



Scottish Law Commission
promoting law reform

| (DISCUSSION PAPER No 162)

Review of Contract Law

Discussion Paper on Penalty Clauses

discussion
paper



Scottish Law Commission
promoting law reform

Review of Contract Law

Discussion Paper on Penalty Clauses

November 2016

DISCUSSION PAPER No 162

This Discussion Paper is published for comment and criticism and does not represent the final views of the Scottish Law Commission

NOTES

1. Please note that information about this Discussion Paper, including copies of responses, may be made available in terms of the Freedom of Information (Scotland) Act 2002. Any confidential response will be dealt with in accordance with the 2002 Act.

We may also (i) publish responses on our website (either in full or in some other way such as re-formatted or summarised); and (ii) attribute comments and publish a list of respondents' names.

2. Where possible, we would prefer electronic submission of comments. A [downloadable electronic response form](#) for this paper as well as a [general comments form](#) are available on our website. Alternatively, our general email address is info@scotlawcom.gsi.gov.uk.

3. Please note that all hyperlinks in this document were checked for accuracy at the time of final draft.

4. If you have any difficulty in reading this document, please contact us and we will do our best to assist. You may wish to note that the pdf version of this document available on our website has been tagged for accessibility.

5. © Crown copyright 2016



You may re-use this publication (excluding logos and any photographs) free of charge in any format or medium, under the terms of the Open Government Licence v3.0. To view this licence visit <http://www.nationalarchives.gov.uk/doc/open-government-licence/version/3>; or write to the Information Policy Team, The National Archives, Kew, Richmond, Surrey, TW9 4DU; or email psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

This publication is available on our website at <http://www.scotlawcom.gov.uk>.

Any enquiries regarding this publication should be sent to us at info@scotlawcom.gsi.gov.uk.

ISBN: 978-0-9935529-4-6

The Scottish Law Commission was set up by section 2 of the Law Commissions Act 1965 (as amended) for the purpose of promoting the reform of the law of Scotland. The Commissioners are:

The Honourable Lord Pentland, *Chairman*
Caroline Drummond
David Johnston QC
Professor Hector L MacQueen
Dr Andrew J M Steven.

The Chief Executive of the Commission is Malcolm McMillan. Its offices are at 140 Causewayside, Edinburgh EH9 1PR.

The Commission would be grateful if comments on this Discussion Paper were submitted by 24 February 2017.

Please ensure that, prior to submitting your comments, you read notes 1-2 on the facing page. Respondents who wish to address only some of the questions and proposals in the Discussion Paper may do so. All non-electronic correspondence should be addressed to:

Anna Mackinnon
Scottish Law Commission
140 Causewayside
Edinburgh EH9 1PR

Tel: 0131 668 2131

Contents

Contents	iv
Abbreviations.....	vii
Chapter 1 Introduction.....	1
Scottish Law Commission’s review of contract law	1
Previous SLC Reports as starting points	2
Structure of the Discussion Paper	3
General options for reform.....	4
Advisory Group	4
Impact assessment	4
Legislative competence.....	5
Chapter 2 The 1999 Report and Some Comparative Law	6
Introduction	6
The classic case.....	7
Summary of recommendations in Report	9
A more realistic judicial test for penalty clauses.....	9
Penalties arising otherwise than on breach	10
The form of a penalty.....	10
Court powers	11
Other matters	12
Scottish Government consultation (2010).....	12
The DCFR (2009).....	14
Civil law jurisdictions	15
France.....	15
Germany	16
Netherlands.....	17
Reform proposals in Civil law jurisdictions	18
‘Mixed’ jurisdictions	19
South Africa.....	19
Louisiana.....	19
Quebec.....	19
Israel	20
Conclusion	20

Chapter 3	<i>Cavendish/ParkingEye</i> and the New Common Law Approach	21
	Andrews v Australia and New Zealand Banking Group Ltd.....	22
	<i>Cavendish/ParkingEye</i>	23
	<i>Cavendish/ParkingEye</i> : abolition denied but Lord Dunedin’s tests de-throned.....	25
	<i>Cavendish/ParkingEye</i> : the breach requirement; primary and secondary obligations	27
	<i>Cavendish/ParkingEye</i> : the true test of penalty; legitimate interests	29
	<i>Cavendish/ParkingEye</i> : form of penalty	30
	<i>Cavendish/ParkingEye</i> : forfeiture of deposits; unenforceability and judicial modification	31
	<i>Cavendish/ParkingEye</i> : the application of the new rules.....	33
	(i) Application in <i>Cavendish</i>	33
	(ii) Application in <i>ParkingEye</i>	34
	Case law subsequent to <i>Cavendish/ParkingEye</i>	35
	Scotland	35
	England & Wales.....	37
	Australia	38
	Conclusions.....	40
Chapter 4	Law Reform Options	43
	(1) Do nothing?	46
	(2) Outright abolition?.....	48
	(3) Abolition and replacement?.....	50
Chapter 5	A Replacement Penalties Regime.....	53
	What kinds of clause should be regulated?	53
	Form of penalty	56
	Irritancies?.....	59
	When is a clause excessively penal, and what are the legal effects thereof?	60
	Judicial modification	71
	Onus of proof of penalty	74
	Cumulation of penalty and other remedies	75
	Contracting out.....	76
	Application to bonds and unilateral obligations	76
	Transitional provisions.....	76
	Conclusion	77
Chapter 6	Law Reform Questions and Proposals.....	78

Appendix A.....	83
International instruments	83
Other jurisdictions.....	84
Appendix B.....	87
Judicial Advisory Group.....	87
Advisory Group.....	87

Abbreviations

Cavendish/ParkingEye,

Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67, [2015] 3 WLR 1373, [2016] 2 All ER 519

CLJ,

Cambridge Law Journal

DCFR,

C von Bar and E Clive (eds), *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference (DCFR)* (2009)

DP 1997,

Scottish Law Commission Discussion Paper No 103 on Penalty Clauses (December 1997), available at:
http://www.scotlawcom.gov.uk/files/4412/7892/5856/dp103_penalty_clauses.pdf

Edin LR,

Edinburgh Law Review

ERPL,

European Review of Private Law

Gloag *Contract*,

W M Gloag, *The Law of Contract: A Treatise on the Principles of Contract in the Law of Scotland* (2nd edn, 1929)

Gloag & Henderson,

Lord Eassie and H L MacQueen (eds), *Gloag and Henderson The Law of Scotland* (13th edn, 2012)

JBL,

Journal of Business Law

JCL,

Journal of Contract Law

LQR,

Law Quarterly Review

LMCLQ,

Lloyds Maritime and Commercial Law Quarterly

MacQueen & Thomson *Contract*,

H L MacQueen and J Thomson, *Contract Law in Scotland* (4th edn, 2016)

McBryde *Contract*,

W W McBryde, *The Law of Contract in Scotland* (3rd edn, 2007)

OJLS,

Oxford Journal of Legal Studies

PECL,

Principles of European Contract Law;

Parts I and II (revised 1998) and Part III (2002) available at:
<http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/>

PICC,

The UNIDROIT Principles of International Commercial Contracts (3rd edn, 2010),
available at:

<http://www.unidroit.org/english/principles/contracts/principles2010/blackletter2010-english.pdf>

Report 1999,

Report on Penalty Clauses (Scot Law Com No 171, 1999), available at
<http://www.scotlawcom.gov.uk/files/1812/7989/6621/rep171.pdf>

SME,

The Laws of Scotland (Stair Memorial Encyclopaedia), 25 Volumes with Reissues

ZEuP,

Zeitschrift für Europäisches Privatrecht

Chapter 1 Introduction

Scottish Law Commission's review of contract law

1.1 We are currently undertaking a general review of Scots contract law in the light of the Draft Common Frame of Reference (DCFR). This is being conducted as part of our Ninth Programme of Law Reform.¹

1.2 The DCFR was published in 2009, as part of a pan-European effort to promote more consistent and coherent legislation across the European Union in the field of contract law. It elaborated the preceding Principles of European Contract Law (PECL), completed and published in 2003. The DCFR underpinned the European Commission's now abandoned proposal for a Common European Sales Law (the proposed CESL).² The comparative information in the DCFR also facilitates our statutory task of keeping the law under review and obtaining information about the law of other countries in pursuit of that function.³ In previous publications in this project we have drawn attention to the influence that the DCFR is having in the reform of the domestic laws of the European Union (EU) member states.⁴

1.3 The impending exit of the United Kingdom (UK) from the EU following the referendum held on 23 June 2016 does not seem to us to lessen in any way the need to ensure that Scots contract law is kept up-to-date and in line with or ahead of international standards. The importance of the EU and its individual member states as trading partners for Scotland as well as the rest of the UK will continue notwithstanding the UK's departure. Nor has there been any diminution of the need to make our law as useful and useable as possible in order to ensure its value, not only to any foreigner wishing to do business in Scotland, but also to those doing business from as well as entirely within this jurisdiction. It thus seems sensible to continue using the DCFR as an international benchmark in our considerations of contract law reform, while not of course neglecting other sources of guidance. These include other 'soft law' international instruments, in particular the UNIDROIT Principles of International Commercial Contracts (the third edition of which was published in 2010).

1.4 It should be re-emphasised, however, that the objective of this review of contract law has never been the adoption of the DCFR as a legislative statement for Scots law. First and foremost, the review has used the DCFR as a 'health check' or 'yardstick' for the existing Scots law of contract. The results may indicate whether legislative intervention is required in pursuit of this Commission's general objectives of simplification and modernisation of the

¹ This can be found at <https://goo.gl/G74ORJ>; the review was begun under the Eighth Programme of Law Reform which ran from 2010-2014.

² In May 2015 the Commission moved on to propose instead of the CESL new rules within its Digital Single Market Strategy to 'clarify' contractual rights in cross-border electronic commerce. Two draft Directives were published at the end of 2015: see proposed Directive on certain aspects concerning contracts for the supply of digital content (COM/2015/0634) and proposed Directive on certain aspects concerning contracts for the online and distance sales of goods (COM/2015/0635).

³ Law Commissions Act 1965, s 3.

⁴ See most recently Report on Third Party Rights (Scot Law Com No 245 2016) para 1.2.

law. Our recommended reform of third-party rights in contract exemplifies this.⁵ The check may also throw up issues that are not directly considered in the DCFR, such as ‘execution in counterpart’, legislated for in the Legal Writings (Counterparts and Delivery) (Scotland) Act 2015 following our Report on the subject in 2013.

Previous SLC Reports as starting points

1.5 The starting point for our work on the review of contract law, apart from responding to specific suggestions, was a series of Reports on various aspects of the subject which we published in the 1990s. Each one of these had considered the then-existent instruments preceding the DCFR in developing its reform proposals. Only one, the Report on Three Bad Rules in Contract Law,⁶ was implemented, by the Contract (Scotland) Act 1997. Four others remain unimplemented:

- Report on Formation of Contract: Scottish Law and the United Nations Convention on Contracts for the International Sale of Goods (Scot Law Com No 144, 1993);
- Report on Interpretation in Private Law (Scot Law Com No 160, 1997);
- Report on Penalty Clauses (Scot Law Com No 171, 1999);
- Report on Remedies for Breach of Contract (Scot Law Com No 174, 1999).

1.6 The reasons for this non-implementation are not easy to discern. There does not seem to have been any significant opposition to the substance of the Reports at the time. Those published in the later 1990s might have seemed suitable for implementation in the Scottish Parliament after its establishment in 1999. But the immediate priorities in civil law legislation then were the abolition of feudalism and associated reforms of property law.⁷ With the passage of two decades and more since the Reports were published, we did not think it right simply to press as far as we are able for their implementation without further consideration of the issues raised within each of them. Quite apart from the general evolution of the law and related practice in Scotland over that period, international—and, in particular European—developments in contract law needed to be taken into account. There was, therefore, a case for reconsidering the topics of the Reports, but this time taking into account the DCFR text as well as the preceding instruments, plus any other relevant developments in other jurisdictions, not least England & Wales.

1.7 The first stage of a new review of the law on penalty clauses is a return to our unimplemented Report and draft Bill and its preceding Discussion Paper.⁸ But on this occasion, quite apart from the DCFR, we have to consider the topic in the light of a major upheaval in the domestic law resulting from a decision of the UK Supreme Court in November 2015. The conjoined cases of *Cavendish Square Holding BV v Talal El Makdessi*

⁵ See Report on Third Party Rights (Scot Law Com No 245, 2016). The Report will be implemented by a Contract (Rights of Third Parties) (Scotland) Bill announced in the First Minister’s Programme for Government published on 6 September 2016.

⁶ Scot Law Com No 152, 1996. Note also the Requirements of Writing (Scotland) Act 1995, which implemented the Report on Requirements of Writing (Scot Law Com No 112, 1988).

⁷ This involved the implementation of a number of Reports of this Commission, e.g. the Report on Abolition of the Feudal System (Scot Law Com No 168, 1999), implemented by the Abolition of Feudal Tenure etc. (Scotland) Act 2000.

⁸ Report 1999; DP 1997.

and *ParkingEye Limited v Beavis* recast English—and, it is thought, Scots—law in a way which took into account (although not implementing, at least in full) the proposals for reform which we had made in 1999.⁹ Lord Hodge’s judgment in the cases addresses Scots law directly, and we have worked on the footing that, despite its technically obiter character in that regard, this is likely to be at least highly persuasive if not authoritative in the Scottish courts. There is no questioning of its authority in the first Scottish case in which it was judicially discussed by an Extra Division of the Inner House.¹⁰ Lord Hodge also referred to continental domestic laws, and to ‘soft law’ proposals such as the PECL, the UNIDROIT Principles and the DCFR, to support the argument that “abolition of the rule against penalties would go against the flow of legal developments both nationally and internationally”.¹¹ The court as a whole clearly saw itself as carrying out a revision of the common law of England & Wales, with the prime comparative tool therefore being the law of other Common law jurisdictions. But the result was, as we will show in more detail later in this Discussion Paper, to bring the law significantly closer to that found elsewhere in Europe and in the DCFR.

Structure of the Discussion Paper

1.8 We have divided the Paper into six chapters. We have opted for a more or less chronological approach, starting in Chapter 2 with a summary of our 1999 Report (including overviews of the ‘soft law’ instruments then extant) and the reaction to it when the Scottish Government consulted upon its draft Bill eleven years later. The Chapter then has a discussion of the DCFR provisions on penalty clauses. This is chiefly with a view to analysing how it developed its predecessor instruments, but the opportunity is also taken to show the ‘fit’ with the position in other Continental and mixed jurisdictions. Chapter 3 turns to describe the *Cavendish Square* and *ParkingEye* decisions, also setting them in the wider context of developments in other Common law jurisdictions (notably Australia), as well as comparing the outcome with the recommendations of our 1999 Report and the DCFR. Finally, Chapters 4 and 5 discuss options for reform (including the possibility of taking no further action at this stage in the law’s development), and seeks the views of consultees on these matters. Readers familiar with the law and practice of penalty clauses may wish to turn to these Chapters straightaway. Chapter 6 simply lists the questions on which we seek the views of consultees.

1.9 The reform of the rule against penalties was first considered by our colleagues at the Law Commission for England & Wales in 1975, and we have followed them in one terminological point which they summarised as follows:

“To avoid a lengthy circumlocution we shall in this paper talk of ‘penalty clauses’ to include enforceable (or arguably enforceable) and unenforceable provisions, and no presumption that a ‘penalty clause’ is unenforceable will arise unless the context so requires.”¹²

⁹ *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* [2015] UKSC 67, [2015] 3 WLR 1373, [2016] 2 All ER 519 (henceforth *Cavendish/ParkingEye*).

¹⁰ *Gray v Braid Group (Holdings) Ltd* 2016 SLT 1003. See further below paras 3.46-3.51.

¹¹ *Cavendish/ParkingEye* at paras 263-265. Lords Neuberger, Sumption and Mance also referred to this material (apart from the DCFR) in rejecting the argument for the abolition of the rule against penalties: see *ibid*, paras 37, 164, 165.

¹² Law Commission Working Paper No 61, *Penalty Clauses and Forfeiture of Moneys Paid* (1975) para 9.

General options for reform

1.10 We offer three alternative possibilities for action (or inaction):

- (1) leave the law to develop in the light of the *Cavendish/ParkingEye* decision;
- (2) abolish the present common law on penalty clauses altogether;
- (3) abolish the present common law against penalties and replace it with a new regime.

1.11 The last involves making the law's starting point the general enforceability rather than the unenforceability of penalty clauses, with regulation only occurring where, in the terminology we have developed for the purposes of this Discussion Paper, the penalty is 'excessively penal'. Within this we canvas various further options, such as the kinds of contract term to be regarded as subject to regulation if excessively penal, the forms that a penalty may take, the factors to be considered in determining 'excessive penalty', and whether 'excessively penal' clauses should be treated as unenforceable and/or subject to judicial modification.

1.12 At this stage we are not committed to any of these various possibilities, and our final recommendations will be strongly guided by consultees' responses to our questions. It should perhaps be made clear here, however, that we do not intend to recommend any change to the existing law on unfair terms in consumer contracts, which covers penalty clauses. The law, now found in Part 2 of the Consumer Rights Act 2015, implements an EU Directive but we do not anticipate any change to the legal position upon the UK leaving the EU. We do however refer to this law when relevant.

Advisory Group

1.13 We are very grateful to those who have provided advice to us in the course of the preparation of our Discussion Paper. In order to come up with proposals in this area we needed to gain an understanding of the problems currently faced in practice. The Advisory Group, whose members are listed in Appendix B, provided invaluable assistance in this regard. We also received valuable help from a Judicial Advisory Group of three Court of Session judges, also listed in Appendix B. None of the members of these advisory groups is to be held to have taken any substantive position on the various reform options discussed in this paper, which none of them has seen in its final version.

Impact assessment

1.14 It is essential for us to attempt to assess the impact, particularly the economic impact, of any reform proposal that we may eventually recommend in the Report which will follow on from this Discussion Paper. We would be especially grateful for any evidence with which we can begin to quantify the issues raised, whether that evidence relates to the current situation or is concerned with the possible effects of any reform of the law. Clearly, assessment of the likely economic impact of a possible reform depends substantially on the economic impacts of the present law. Information on why and how parties use penalty clauses in their contracts, and on any effects arising when they are deployed, will also be extremely helpful.

1.15 A particular issue on which we would welcome more information is the impact of penalty clauses on small and medium-sized enterprises. A survey published by the Federation of Small Businesses in August 2016 quantified the negative financial impact on Federation members of unfair contract terms in supplier contracts. In particular, one-fifth of those surveyed had had detrimental experience of ‘high early termination charges’ – that is, contractual provisions to which the rule against penalties is at present only doubtfully applicable.¹³

1.16 To assist us in our task of law reform as well as impact assessment, we ask:

- 1. Do consultees know of information or statistical data or have comments on any actual or potential economic impacts of either the current law relating to penalty clauses or any proposed reform of that law? We would especially value information about why and how penalty clauses are used, the effects of their deployment, and their impact on small and medium-sized enterprises.**

Legislative competence

1.17 In our view, the proposals of the Discussion Paper would, if enacted, be within the legislative competence of the Scottish Parliament. The proposals relate to the Scots private law of obligations, in particular, contract law, which is not reserved in terms of the Scotland Act 1998.¹⁴ We are also of the view that the proposals, if enacted, would not give rise to any breach either of the European Convention on Human Rights or European Union law.

¹³ For the FSB survey, see <https://goo.gl/r57Htv>. On early termination charges see further paras 5.7-5.9 below.

¹⁴ The meaning of ‘Scots private law’ is given in s 126(4) of the Scotland Act 1998 and includes the law of obligations.

Chapter 2 The 1999 Report and Some Comparative Law

Introduction

2.1 As a general rule, the victim of a breach of contract may recover damages representing compensation for its loss from the perpetrator of the breach. The law on contract damages is however 'default' in nature, in that contracts can provide their own scheme for payment of a sum or other remedy by the perpetrator of a breach of contract. The advantages of doing so for the contracting parties are the facilitation of contingency planning, the avoidance of disputes and litigation, and the consequent reduction of uncertainty about the outcomes of breach. Under Scots law since the end of the nineteenth century, a distinction has been made between clauses which genuinely pre-estimate the damages payable on a breach of contract, and clauses which do not. Clauses which attempt to provide for the recovery of a genuine pre-estimate of loss have been referred to as liquidated damages and are enforceable. Clauses which provide for a fixed payment to be made instead of damages, but do not base this upon any attempt to pre-estimate loss, have been referred to as penalty clauses, and are unenforceable.¹

2.2 In December 1997, this Commission published a Discussion Paper on Penalty Clauses. The review was prompted by the Faculty of Advocates, which was concerned by the form of contracts for the hire of photocopiers which had been the subject of recent litigation in the Court of Session and the sheriff court (albeit not directly considering the possible application of the penalties rule apart from a quite lengthy obiter dictum by Lord Coulsfield).² The contracts in question contained what we described as "elaborate provisions"³ dealing with early termination on the hirer's insolvency, penalties payable thereupon, and the supplier's entitlement to enter the premises where the photocopier was installed with a power to take possession of the machine. Lord Coulsfield's view, expressed after the point had been argued before him, but not necessary for his decision in the case, was that the clauses were unenforceable penalties in so far as they could be triggered by the hirer's breach of contract and not just by its insolvency.⁴ His decision was affirmed by the First Division without consideration of the penalties question.⁵

2.3 The Discussion Paper identified two main issues with the then Scots law.⁶ First, some contractual provisions, while in no way oppressive or unreasonable, were liable to be

¹ See generally McBryde *Contract* Ch 22 Part 8; *SME* vol 15 paras 783-801.

² See the cases cited in the following footnotes and also *Eurocopy Rentals Ltd v McCann Fordyce* 1994 SLT (Sh Ct) 63; *Common Services Agency v Purdie and Kirkpatrick Ltd*, *Eurocopy (Scotland) plc v Lothian Health Board* 1995 SLT 1356.

³ DP 1997, para 2.31. In one of the cases Sheriff Principal Nicholson (a former Scottish Law Commissioner) described the contract before him as "one of the more bizarre and ill drafted documents that I have ever seen" (*Common Services Agency v Purdie and Kirkpatrick Ltd*, *Eurocopy (Scotland) plc v Lothian Health Board* 1995 SLT (Sh Ct) 34, 40).

⁴ *Eurocopy Rentals Ltd v Tayside Health Board* 1996 SLT 224, 228-229.

⁵ *Eurocopy Rentals Ltd v Tayside Health Board* 1996 SC 410.

⁶ We formulate the matter in this historical fashion since we believe that Scots law is now different following the decision of the UK Supreme Court in *Cavendish/ParkingEye*, for which see further Chapter 3 below.

struck down as unenforceable penalty clauses because, not being pre-estimates of damage, they fell on the wrong side of the line drawn between penalty clauses and liquidated damages. Second, some contractual provisions of an oppressive and unreasonable nature could escape the judicial control over penalty clauses because they were drafted in such a way as not to arise on a breach of contract, or as not involving the post-breach payment of a sum of money by the contract-breaker, thereby taking themselves out of the scope of the penalty rule. Thus, for example, a clause which on its face became enforceable upon a party's insolvency could be extravagant and without any justification, yet escape judicial control, despite the prejudice this could cause to other creditors in the insolvency.

2.4 Following consultation, we recommended reform and in a Report published in 1999 we proposed a new legislative statement of the law on penalty clauses.⁷ The comparative materials considered included the Council of Europe's Resolution on Penal Clauses in Civil Law 1978,⁸ the UNCITRAL Uniform Rules on Liquidated Damages and Penalty Clauses,⁹ the UNIDROIT Principles of International Commercial Contracts (PICC),¹⁰ and the Principles of European Contract Law (PECL).

The classic case

2.5 At the time of our previous Discussion Paper and Report, the case of *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*,¹¹ decided in 1915, was thought to encapsulate the law on penalty clauses in Scotland as well as England. In brief summary of the facts, the plaintiffs were tyre manufacturers who sold their products to trade purchasers at a discount but subject to a term in the contract whereby the latter would not resell the tyres at less than the list price. Breach of this term would lead to a liability of £5 per tyre sold, the list price of a tyre being £4.1.0d. The charge was stated to be by way of liquidated damages rather than as penalty. The term was intended to protect the plaintiffs against their price being undercut in the market, which would disrupt their business structure. It was held not to be an unenforceable penalty.¹²

2.6 Lord Dunedin's speech in *Dunlop* has long been treated as in effect an authoritative statement on how to determine whether a clause was one for liquidated damages or a penalty. In a famous dictum, he set out four guidelines, with four further tests stated in the last of these:

“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*¹³ of the offending party; the essence of liquidated damages is a genuine covenanted pre-

⁷ Report 1999, Appendix A.

⁸ Text accessible at <https://goo.gl/YDG6n3>.

⁹ Text accessible at <https://goo.gl/PSf1Nv>. See also DP 1997, para 4.19.

¹⁰ For commentary by Ewan McKendrick on the PICC rules on penalties, see S Vogenauer (ed), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)* (2nd edn, 2015) 1025-1032.

¹¹ [1915] AC 79.

¹² Today, and for at least the last fifty years, it would be illegal as contrary to the law on resale price maintenance.

¹³ This Latin phrase means “with the intention to threaten or intimidate”.

estimate of damage (*Clydebank Engineering and Shipbuilding Co. v. Don Jose Ramos Yzquierdo y Castaneda*¹⁴).

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 (*Public Works Commissioner v. Hills*¹⁵ and *Webster v. Bosanquet*¹⁶).

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 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. (Illustration given by Lord Halsbury in *Clydebank Case*.¹⁷)

(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 (*Kemble v. Farren*¹⁸). This though one of the most ancient instances is truly a corollary to the last test. Whether it had its historical origin in the doctrine of the common law that when A. promised to pay B. a sum of money on a certain day and did not do so, B. could only recover the sum with, in certain cases, interest, but could never recover further damages for non-timeous payment, or whether it was a survival of the time when equity reformed unconscionable bargains merely because they were unconscionable,—a subject which much exercised Jessel M.R. in *Wallis v. Smith*¹⁹—is probably more interesting than material.

(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” (Lord Watson in *Lord Elphinstone v. Monkland Iron and Coal Co.*²⁰).

On the other hand:

(d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties (*Clydebank Case*, Lord Halsbury²¹ ; *Webster v Bosanquet*, Lord Mersey²²).²³

¹⁴ (1904) 7 F (HL) 77, [1905] AC 6.

¹⁵ [1906] AC 368.

¹⁶ [1912] AC 394.

¹⁷ (1904) 7 F (HL) 77, [1905] AC 6.

¹⁸ (1829) 6 Bing 141.

¹⁹ (1882) 21 Ch D 243.

²⁰ (1886) 11 App Cas 332.

²¹ (1904) 7 F (HL) 77 at 78-79, [1905] AC 6 at 11.

²² [1912] AC 394 at 398.

²³ [1915] AC 79 at 86-88.

Summary of recommendations in Report

A more realistic judicial test for penalty clauses

2.7 One of the matters consulted upon was a suitable replacement for the ‘genuine pre-estimate of loss’ test. On consultation, there was support from the legal profession for a move away from this test.²⁴ The criticisms of the test were two-fold. It was argued that the test could lead to perfectly justifiable clauses being held to be unenforceable. In addition, it was stated that the test was particularly difficult to apply, and indeed unrealistic, in those cases where it is impossible to estimate damages in advance; often it is in those cases where penalty clauses are most necessary and useful. In the case of *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda*,²⁵ for example, the late delivery of four torpedo boats, intended for use by the Spanish Government in the war against Cuban independence, led to a penalty of £67,500 (£500 for each week of late delivery of each vessel) being held to be enforceable. At the time of contracting, it would have been impossible to pre-estimate the damage that would result from such a breach, and thus the agreed clause provided a solution to predictable difficulties as well as an incentive to performance in accordance with the contract schedule. The clause in that case was upheld, but the emphasis on the distinction between pre-estimated damages and a penalty clause made it more difficult to uphold such a clause than it would have been with the adoption of a more straightforward approach.

2.8 In our Report, we recommended that the applicable judicial test should instead be whether the penalty is ‘manifestly excessive’, and that penalties which are not manifestly excessive should be enforceable even if they cannot be regarded as based on a genuine pre-estimate of loss.²⁶ The term ‘manifestly excessive’ was favoured as it suggested that the excessive nature of the penalty should be immediately obvious to anyone considering it; it should not be a matter of fine calculation.²⁷ The term itself was derived from the 1978 Resolution of the Council of Europe on Penal Clauses. The justification for its use given there had been quoted at length in our preceding Discussion Paper:

“The main purpose of the clause (i.e. to discourage litigation) would be lost if the court could set it aside too easily, and the court should therefore exercise its power with much discretion. In order to indicate the exceptional character of judicial intervention a number of formulae have been discussed. In addition to the term proposed, namely ‘manifestly excessive’, other terms such as ‘exorbitant’, ‘unconscionable’ (in French ‘*abusive*’), ‘unreasonable’, were considered. However, the term ‘exorbitant’ was felt to restrict too narrowly the power of judicial review; the term ‘unconscionable’ was considered insufficiently precise within the context of judicial review of penal clauses; the term ‘unreasonable’ in English was found when used in this connection to have no acceptable equivalent in French legal terminology. The committee therefore finally decided in favour of the term ‘manifestly excessive’, which is in fact already used in the existing legislation of some member states.”²⁸

²⁴ Report 1999 para 3.1.

²⁵ 1904 7 F (HL) 77, [1905] AC 6.

²⁶ Report 1999, para 3.10.

²⁷ Report 1999, para 3.8.

²⁸ Council of Europe Resolution on Penal Clauses, Explanatory Memorandum, art 7 (para 24); quoted DP 1997, para 4.7.

2.9 The use of ‘grossly excessive’ as in the PICC and the PECL was rejected, perhaps because ‘grossly’ may be thought to invite an element of moral judgement whereas ‘manifestly’ suggests a more dispassionate and objective approach.

Penalties arising otherwise than on breach

2.10 Under the still current law, the control of penalty clauses applies only where there is a breach of contract.²⁹ If a payment or other performance is required on an event other than a breach, the rules on penalties cannot apply. Therefore, it does not apply, for example, where one party exercises a contractual option to perform in one way rather than another, or where a contract is terminated early under its terms. This approach has been criticised on the basis that it seems to favour the party who acts in breach rather than the party who complies with the terms of the contract: the party in breach can seek judicial scrutiny of a penalty whilst the other party may not.³⁰

2.11 The Council of Europe Resolution, the PICC, and the PECL are all framed in terms of payments of sums of money to be made by a party which does not perform its obligations. However, we rejected the approach of restricting the controls to clauses operating upon a failure to perform the contract. This was thought to be too narrow; for example, it would not catch the payment to be made when a party exercised an option under a contract such as terminating it early. Our favoured approach was rather to define a penalty clause as one operating upon a breach of contract, or a failure to perform or to perform in a particular way, or an early termination of the contract.³¹ A provision to this effect was included in the draft Bill.³² The Report noted:

“In expressing our proposal in this limited way, rather than just referring to penal provisions generally, we were attempting to distinguish between sanctions due on breach or some other abnormal event and any consideration due in respect of the performance of the contract in the normal way. We had no wish to subject ordinary bad bargains to judicial control.”³³

The form of a penalty

2.12 Under the law current at the time of the Report, a penalty clause was usually one in the form of an obligation to pay a sum of money. There was Scottish authority that a provision for a transfer of property can constitute an unenforceable penalty.³⁴ But other forms of clause might avoid being subjected to judicial scrutiny even though their effect was clearly penal: for example, a forfeiture of money already paid prior to breach (e.g. a deposit).³⁵

²⁹ This continues to be the position following the Supreme Court decision in *Cavendish/ParkingEye*. For previous Scottish decisions on the point see *City Inn Ltd v Shepherd Construction Ltd* 2002 SLT 781 affirmed 2003 SLT 885; *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399; *Bell Brothers (HP) Ltd v Aitken* 1939 SC 577; *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296; *EFT Commercial Ltd v Security Change Ltd* 1992 SC 414.

³⁰ Report 1999, para 4.4.

³¹ DP 1997, para 4.23. See paras 4.20-4.22 for an analysis of the other options considered.

³² Penalty Clauses (Scotland) Bill, s 1(3). See Report 1999, Appendix A.

³³ Report 1999, para 4.7.

³⁴ *Watson v Noble* (1885) 13 R 347. See also in England & Wales *Jobson v Johnson* [1989] 1 WLR 1026 (to some extent disapproved in *Cavendish*).

³⁵ *Zemhunt (Holdings) v Control Securities plc* 1992 SC 58.

2.13 In our Report, we considered whether the particular form of a penalty should have any impact on the applicability of judicial control. We recommended that judicial control over contractual penalties should apply whether the penalty was expressed in monetary terms or in some other way. The basis of our recommendation was that there was no apparent reason why a provision should escape control simply because it is in the form of a penalty other than the payment of money.³⁶ The draft Bill contained a provision extending the definition of penalty beyond an obligation to pay a sum of money.³⁷

2.14 We also considered whether irritancies in a lease should be subject to the same judicial control as contractual penalties.³⁸ By a narrow majority,³⁹ we recommended that the judicial scrutiny over contractual penalties should not apply to the law on irritancies in leases of land. We subsequently consulted on the law on irritancies in leases of land as part of the Sixth Programme of Law Reform.⁴⁰ The reforms we recommended then have not been implemented in legislation.

Court powers

2.15 In our Report we also made recommendations in relation to the powers of a court dealing with a claim that something due under a contract is a manifestly excessive penalty.

2.16 We recommended that the excessive penalty of a clause should be judged according to all the circumstances, including circumstances arising since the contract was entered into, and not just those prevailing at the time the contract was formed. A majority of the consultees were of the view that the enforceability of a penalty should be so judged. Consultees recognised that it was “often frustrating and artificial”⁴¹ to prevent all the circumstances being taken into account in determining enforceability.⁴²

2.17 We further recommended that a court deciding on a penalty clause should have power to modify a manifestly excessive penalty so as to make it enforceable: for example, by reducing its amount, or by attaching conditions to the exercise of the relevant right. Such a power existed at common law in Scotland before 1900, although its scope was uncertain;⁴³ moreover section 5 of the Debts Securities (Scotland) Act 1856 (still in force today) provides that

“... in all cases where penalties for non-payment, over and above performance, are contained in bonds or other obligations for sums of money, and are made the subject of adjudication, or of demand in any other shape, it shall be in the power of the court to modify and restrict such penalties, so as not to exceed the real and necessary expenses incurred in making the debt effectual.”

2.18 Most of the consultees were of the view that the courts should have a general power of modification to deal with manifestly excessive penalties. Their views were based on the potential saving of resources of the parties and courts upon a finding of penalty, given that a

³⁶ Report 1999, para 5.6.

³⁷ Penalty Clauses (Scotland) Bill, s 1(3).

³⁸ Report 1999, paras 5.10 – 5.16.

³⁹ The majority was formed by Lord Gill, Patrick Hodge QC (now Lord Hodge of the UK Supreme Court), and Niall Whitty. The dissentients were Dr Eric Clive and Professor Kenneth Reid.

⁴⁰ See DP No 117, 2001 and Scot Law Com No 191, 2003.

⁴¹ Report 1999, para 6.10.

⁴² Penalty Clauses (Scotland) Bill, s 1(4).

⁴³ Report 1999, para 6.14; see also DP 1997, paras 2.2-2.4, 2.7, 2.10.

further action for ordinary damages or other remedy would not be required,⁴⁴ and the belief that such a provision would be necessary, given the recommendation to extend control of penalties beyond breach of contract.⁴⁵ The draft Bill included a provision to this effect.⁴⁶

Other matters

2.19 In our Report we made several ancillary recommendations in relation to the proposed draft Bill. We recommended that:

- a provision should be included stating that the parties cannot contract out of the application of the law in relation to penalty clauses;⁴⁷
- the onus of showing that a clause is an unenforceable penalty should lie on the party who makes the allegation;⁴⁸
- the rules should apply to clauses in bonds and other unilateral voluntary obligations in the same way as to contracts;⁴⁹
- any new legislation should apply only to clauses agreed after it comes into force;⁵⁰ but
- it would be unnecessary to state that a party is unable to recover both the penalty and damages for the same act.⁵¹

Scottish Government consultation (2010)

2.20 The Scottish Government consulted on the draft Penalty Clauses (Scotland) Bill in 2010.⁵² Consultees' responses were however divided by comparison with the 1990s. Those in favour of the Bill identified several benefits. Some recognised that it would provide greater clarity in the law.⁵³ Furthermore, the flexibility the legislation would give to businesses in providing contractually to encourage their counterparties to perform contracts was welcomed.

2.21 But consultees also expressed several concerns about a wide approach to what constitutes a penalty clause. Some respondents referred in particular to the Financial Collateral Directive, introduced by the European Parliament and Council in 2002.⁵⁴ The Directive creates a uniform EU legal framework to limit credit risk in financial transactions through the provision of securities and cash as collateral.⁵⁵ In particular, Article 6 provides

⁴⁴ Report 1999, para 6.20.

⁴⁵ Report 1999, para 6.20.

⁴⁶ Penalty Clauses (Scotland) Bill, s 4.

⁴⁷ Report 1999, para 7.1.

⁴⁸ Report 1999, paras 7.6- 7.8.

⁴⁹ Report 1999, para 7.9.

⁵⁰ Report 1999, paras 7.10- 7.11.

⁵¹ Report 1999, paras 7.2- 7.5.

⁵² <https://goo.gl/cDqa7j>. Responses are available at: <https://goo.gl/Bw99ds>.

⁵³ See the responses of Aberdeen City Council, North Lanarkshire Council, Rangers Football Club, Scottish Premier League and St Johnstone Football Club available at: <https://goo.gl/Bw99ds>.

⁵⁴ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements. The Directive is implemented for the United Kingdom by the Financial Collateral Arrangements (No 2) Regulations, 2003 (SI 2003/3226).

⁵⁵ <https://goo.gl/kNjRqz>. See now Geoffrey Yeowart and Robin Parsons *The Law of Financial Collateral* (2016), which includes a chapter (23) on Scots law written by Hamish Patrick.

that a clause drafted by the parties for the transfer of title within a financial collateral arrangement should be given effect by Member States. Such an arrangement can include a clause whereby collateral provided by the security-giver may be forfeited to the security-taker, even if the value of the collateral is greater than the underlying debt. It was suggested that a 'carve-out' would be needed for these arrangements were the Bill to be brought forward for enactment.⁵⁶

2.22 Another area of concern was derivatives contracts. The Law Society of Scotland explained:

"Under a normal currency swap agreement the amount payable by one party to the other to close-out can vary greatly during the course of that agreement. A non-defaulting party can choose to close out (or not to close-out) relevant swap transactions at any given time and receive (or pay) a closing out payment. The amount may vary greatly, depending on when the right to close-out is exercised."

The International Swaps and Derivatives Association (ISDA) prepared a Master Agreement and associated documentation which is in widespread international use for such transactions.⁵⁷ The Committee of Scottish Clearing Bankers elaborated upon the dangers:

"The International Swaps and Derivatives Association (ISDA) has responsibility for minimising the risks in the different jurisdictions in which derivative products are used. Scotland is currently viewed as a "clean" jurisdiction as no significant risks have been identified in regard to termination or close-out netting in Scotland. In the event that the Bill becomes law Scotland may be considered a less attractive location to conduct derivatives business."⁵⁸

The Society drew attention to a recent English case, *BNP Paribas v Wockhardt EU Operations (Swiss) AG*,⁵⁹ in which, however, the Commercial Court had held such a 'closing-out' provision not to be a penalty under the then law. The clause in the ISDA Master Agreement under review in the case was one triggered by breach.

2.23 Dr Ross Anderson and the Law Society of Scotland also raised concerns about what they said was the widespread use of 'resolutive conditions' in commercial contracts in Scotland – that is, provisions about how a contract may be brought to an end early and with what other effects for the parties. Dr Anderson stated that:

"... many resolutive condition clauses have developed as a result of custom and practice in the market over a long period of time... As presently drafted, s 1 of the Bill could potentially apply to resolutive conditions, thus giving rise to some uncertainty about their enforceability."⁶⁰

Common examples were said to be found in loan agreements and intellectual property licences. They often provide for forfeiture, basing themselves upon the non-applicability of the penalties rule to forfeiture clauses in Scots law. The Society expressed further worries about terms of contracts providing for suspension of performance by a party, suggesting that such terms are frequently included in 'bespoke commercial contracts'.

⁵⁶ Dr Ross Anderson and The Law Society of Scotland. Responses available at: <https://goo.gl/01G00K>. See further para 5.19 and footnote 27 thereto below.

⁵⁷ See generally the ISDA website, <http://www2.isda.org/>.

⁵⁸ Response 14-The Committee of Scottish Clearing Bankers available at: <https://goo.gl/zvKGr2>.

⁵⁹ [2009] EWHC 3116 (Comm).

⁶⁰ Penalty Clauses Bill 2010-Consultation Response 04 (Dr Ross Anderson), para 3.1.3.

2.24 Some consultees were of the view that the proposed legislation would increase uncertainty in the commercial context.⁶¹ The extension of the penalties rule to situations where there is no breach of contract, and the introduction of the ‘manifestly excessive’ test, were questioned. Concerns were expressed about enabling a court to alter the amount payable, and to take into account events happening after the making of the contract. The law firm McGrigors stated that “the lack of guidance as to how the term is to be interpreted causes uncertainty”.⁶² It was suggested that the level of uncertainty would be disadvantageous for Scots law when compared with English law.⁶³ In addition, concerns were raised as to the increased costs for parties, such as that associated with extended contractual negotiations between parties to mitigate the risk associated with the uncertainty, and potentially increased litigation costs associated with interpretation of clauses in light of a new judicial test.⁶⁴

2.25 The Scottish Government decided that further work was necessary to determine whether consultees’ concerns could be alleviated before a Bill was taken further.⁶⁵ It accordingly requested that the Scottish Law Commission re-consider penalty clauses as part of the wider review of contract law.⁶⁶

The DCFR (2009)

2.26 The DCFR essentially adjusts some of the wording but not the substance of the provisions of the PECL and the PICC used in the 1999 Report. Terms in an obligation requiring the debtor who fails to perform the obligation to pay a specified sum to the creditor for such non-performance are enforceable by the creditor irrespective of the actual loss. There is however judicial control where the specified sum is ‘grossly excessive’. This falls to be determined in relation to the actual loss suffered and the other circumstances. The control does not take the form of striking the provisions down; instead the judge is empowered to reduce the specified sum to a reasonable amount. This judicial power cannot be evaded by a contrary contractual provision.⁶⁷

2.27 The comments on the relevant article of the DCFR offer no specific justification for the choice of ‘grossly’ over ‘manifestly’ or other alternatives. Nor did the DCFR seek to meet the difficulties with the scope of the controls identified in our reform exercise between 1997 and 1999 in considering the UNIDROIT Principles and the PECL. The position that penal clauses within scope (i.e. arising on a party’s failure of performance) are enforceable is maintained. Further, there is no alternative to the modification of the grossly excessive penalty; the court has no power to strike the clause down altogether or render it unenforceable. Another point worth making is that the DCFR says nothing explicitly about the validity of terms which do genuinely pre-estimate the loss that would flow from a breach of contract. That such terms are valid and enforceable follows, however, from penalty

⁶¹ See the responses of Dr Ross Anderson, the Law Society of Scotland, Balfour Beatty, Dundas & Wilson, McGrigors LLP and The Committee of Scottish Clearing Bankers available at: <https://goo.gl/01G00K>.

⁶² Response 13-McGrigors available at: <https://goo.gl/L3HmoQ>.

⁶³ See the responses of Dr Ross Anderson, the Law Society of Scotland, Balfour Beatty, Dundas & Wilson, McGrigors LLP and The Committee of Scottish Clearing Bankers available at: <https://goo.gl/01G00K>.

⁶⁴ See the responses of Dr Ross Anderson, Balfour Beatty, the Law Society of Scotland, Dundas & Wilson, McGrigors and The Committee of Scottish Clearing Bankers available at: <https://goo.gl/01G00K>.

⁶⁵ Penalty Clauses (Scotland) Bill: Scottish Government Consultation: Summary Analysis Report, p 1, available at: <https://goo.gl/Cpw2qK>.

⁶⁶ Penalty Clauses (Scotland) Bill: Scottish Government Consultation: Summary Analysis Report, p 1, available at: <https://goo.gl/Cpw2qK>.

⁶⁷ DCFR III.-3:712.

clauses in general being enforceable as well as the DCFR's general approach favouring freedom of contract and the consequent position that, unless otherwise provided (which is not the case with the rules on non-performance and damages) its rules are default in nature, subject to what the parties agree.⁶⁸

2.28 The DCFR also incorporated elsewhere relevant material derived from Council Directive 93/13/EEC on unfair terms in consumer contracts, which had provided in its indicative list of non-negotiated terms which might be regarded as unfair in that context, and so unenforceable, not only one "requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation", but also another "permitting the seller or supplier to retain sums paid by the consumer where the latter decides not to conclude or perform the contract, without providing for the consumer to receive compensation of an equivalent amount from the seller or supplier where the latter is the party cancelling the contract".⁶⁹

2.29 There are two main points of interest in these provisions for present purposes (which are not confined to consumer protection). First, 'grossly excessive' is replaced by 'disproportionately high' (probably a derivation from German law, as will be seen below). The text does not say to what the 'disproportion' should relate, but presumably it was meant to be at least the loss suffered by the creditor in the consumer's primary but unperformed obligation. Second, as the Court of Justice of the European Union has confirmed, there is no judicial power of modification under the Unfair Terms Directive; the penalty clause either stands or falls altogether under these controls.⁷⁰ Likewise under the DCFR the unfair penalty term is "not binding on the party who did not supply it" and there is no judicial power of revision.⁷¹

2.30 We should also note here that the Unfair Terms Directive is now implemented in the UK by Part 2 of the Consumer Rights Act 2015, and that both of the terms mentioned form part of the indicative list of unfair terms in Schedule 2 of that Act.⁷²

Civil law jurisdictions

2.31 In its recognition of the general enforceability of penalty clauses subject to a power of judicial modification for extreme cases, the DCFR sits firmly within what might be called the mainstream of Continental law on the subject, stemming ultimately from Roman law.⁷³

France

2.32 The original version of the French *Code Civil* (1804) provided simply that "When the agreement provides that the party who fails to perform shall pay a certain sum on account of damages, no larger or smaller sum can be awarded to the other party", i.e. the contract replaced the general law on damages, and the job of the court was to enforce the

⁶⁸ DCFR II.-1:102(2), 103(3); III.-1:108(1).

⁶⁹ Council Directive 93/13/EEC art 3(3) and annex (d) and (e); replicated in DCFR II.-9:410(1)(d), (e). These also made their way into the proposed Common European Sales Law 2011, which otherwise had no provision on penalties.

⁷⁰ Case C-488/11 *Dirk Frederik Asbeek Brusse, Katarina de Man Garabito v Jahani BV* [2013] 3 CMLR 45.

⁷¹ DCFR II.-9:408(10).

⁷² Consumer Rights Act 2015 Sch 2 Part 1 paras 5 and 6.

⁷³ See R Zimmermann, *The Law of Obligations; Roman Foundations of the Civilian Tradition* (1990) 95-106 on the enforceability of *stipulationes poenae* in Roman law.

agreement, with no power even of modification.⁷⁴ This was changed, however, in a *loi* first passed in 1975 and amended ten years later, giving a judge the power of his own motion or otherwise to reduce or increase a “manifestly excessive or derisory” agreed penalty. The parties could not evade this control by alternative provision in their contract.⁷⁵ The position of basic enforceability is continued in substance in the reform of the French law of obligations which came into force on 1 October 2016: the test for judicial modification continues to be whether the stipulated sum is ‘*manifestement excessive ou dérisoire*’.⁷⁶

Germany

2.33 Although the *Code Civil* had a provision allowing an agreed penalty to be adjusted by a court where the debtor had made performance in part, to the extent of the creditor’s benefit thereby,⁷⁷ the German BGB of 1900 probably set the pace amongst subsequent codified systems with regard to such judicial modification.⁷⁸ While the creditor is entitled to demand the performance of a contractual penalty (*Vertragsstrafe*), one that is ‘disproportionately high’ (*unverhältnismäßig hoch*) may be reduced to a reasonable amount by a court. Reasonableness is determined having regard to every legitimate interest of the creditor and not just his ‘patrimonial interest’ (*Vermögensinteresse*).⁷⁹ The control applies if the penalty is undertaken for the debtor doing or forbearing from some act, but not if the penalty has already been paid or, under the HGB (Commercial Code), if the penalty has been undertaken by a merchant operating a commercial concern.⁸⁰ Such a penalty may however be struck down as contrary to public policy under BGB §138.⁸¹

2.34 The BGB also recognises that non-performance or improper performance (e.g. late performance) may each be the subject of a penalty, but in the case of non-performance only the penalty may be claimed (i.e. there is no question of a specific implement order in relation to the principal obligation).⁸² In both cases, however, loss over and above the amount of any monetary penalty may be claimed as damages.⁸³ The possibility of non-monetary penalties is

⁷⁴ Art 1152-1 CC.

⁷⁵ Art 1152-2 CC. Note also arts 1226-1233 CC (‘Of Obligations with Penalty Clauses’), discussed by S Rowan *Remedies for Breach of Contract : A Comparative Analysis of the Protection of Performance* (2012) 197-198, and M Cannarsa ‘Contractual Penalties in French Law’ (2015) 23 ERPL 297-308, 299-301.

⁷⁶ The reform of the French law of obligations promulgated in February 2016 came into force on 1 October 2016 : Ordonnance n° 2016-131 du 10 février 2016 *portant réforme du droit des contrats, du régime général et de la preuve des obligations*, accessible at: <https://goo.gl/AxlucC>. See its Art 1231-5. The preceding Arts 1226-1233 CC (“hardly ever applied and their meaning [was] controversial” (J Cartwright, S Vogenauer and S Whittaker (eds) *Reforming the French Law of Obligations: Comparative Observations on the Avant-projet de réforme du droit des obligations et de la prescription (the ‘Avant-projet Catala’)* (2009) 164)) appear to have been repealed and not replaced in this exercise.

⁷⁷ Art 1231 CC (now repealed; see previous note). See also the Spanish *Código Civil* art 1154. See further para 2.39 below.

⁷⁸ See Zimmermann *Law of Obligations* 108 (noting that “This judicial power to modify a contractual term was clearly recognized as highly exceptional and was accepted only after much toing and froing in the final draft of the BGB.”) The notes to DCFR III.-3:712 (vol 1, pp 965-966) make clear, however, the widespread acceptance of this rule in modern codified systems, including those of eastern Europe, albeit there are variations in the details. For the Italian *Codice civile* art 1384, enacted in 1942 in replacement of an 1865 code based on the *Code Civil*, see F P Patti ‘Penalty Clauses in Italian Law’ (2015) 23 ERPL 309-325.

⁷⁹ §343 BGB.

⁸⁰ §348 HGB.

⁸¹ See F Faust, ‘Contractual Penalties in German Law’, (2015) 23 ERPL 285-296, 292 (discussing a case between a landlord and its brewery tenant).

⁸² §§339-341 BGB. .

⁸³ §§340(2), 341(2) BGB.

also recognised, but any possibility of a compensation claim is barred if the creditor demands the penalty.⁸⁴

2.35 German law seems further to recognise that a term which provides for a pre-estimate of loss flowing from the non-performance of a contract is not to be counted as a penalty. The significance of this is the term's non-susceptibility to the judicial reduction mechanism. Professor Florian Faust says that:

“If a clause is primarily intended to put pressure on the debtor in order to make him perform, it is to be construed as a penalty clause. If, on the other hand, its function is to assist the creditor in bringing a lawsuit to claim damages, then it is to be construed as a liquidated damages clause.”⁸⁵

He goes on to explain that the important factor is how the amount of the payment is calculated, with explicit linkage to ‘damage’, ‘loss’ or ‘lost profits’ pointing towards liquidated damages, and other methods to penalties, “especially if they fix a higher amount”.⁸⁶

Netherlands

2.36 Professor Reinhard Zimmermann explains how the pre-codal Roman-Dutch law departed from the Roman position: “a custom [*came*] to be recognized that if the penalty was much larger than the actual loss suffered, it was within the competence of the court to reduce it ‘ad bonum et aequum’ ...”.⁸⁷ Although this was not followed in the Dutch Civil Code the Burgerlijk Wetboek of 1838 (essentially modelled on the *Code Civil*), the Nieuw Burgerlijk Wetboek of 1992 now provides a relatively recent example of codal recognition that, while penalty clauses are generally enforceable, they are also subject to a judicial power of modification “if it is evident that fairness so requires”.⁸⁸ The modification may be by way of reduction of (although not to less than the damages that would be payable by law), or addition to, the stipulated amount. A feature differentiating the BW from the BGB is that the rules on penalties apply irrespective of whether the clause aims only to repair damage (i.e. is in the nature of a liquidated damages clause) or only to encourage performance (i.e. an outright penalty clause).

2.37 Harriët Schelhaas points out that the difference between Dutch and German law is that, while both systems allow clauses either to regulate the damages payable on a party's breach of contract or to incentivise performance of the contract by way of a penalty, German law does not allow judicial modification of the clause regulating damages only, whereas Dutch law applies the control of judicial modification regardless of the purpose of the clause. French law is to the same effect as Dutch law.⁸⁹ In her view the “clear advantage of the Dutch/French system” is that it is not necessary to work out whether the purpose of the clause is to provide for a damages substitute or a penal incentive:

“This determination of its function may be a difficult task for a court, since the contract virtually never explicitly discloses the exact purpose of the clause, while

⁸⁴ §342 BGB.

⁸⁵ Faust ‘Contractual Penalties in German Law’ 288.

⁸⁶ *Ibid.*

⁸⁷ Zimmermann *Obligations* 109. We may speculate on the influence of this Roman-Dutch position on the seemingly equivalent position in the Scots law of the seventeenth century and later: Stair *Institutions* IV, iii, 2; IV, v 7; IV, xviii, 3.

⁸⁸ BW arts 6.91-6.94.

⁸⁹ H Schelhaas ‘The Judicial Power to Reduce a Contractual Penalty’ [2004] ZEuP 386-398.

contracting parties very often have mixed intentions. They fix a sum of money which replaces the damages recoverable by law and have at the same time the desire to compel the other party to perform. Since it is often difficult to predict what the amount of damages will be and parties must therefore be allowed a margin of appreciation, the amount they have fixed in advance does not easily allow one to ascertain what the purpose of the clause was at the time of the conclusion of the contract. Against this background, assessing the true purpose of the clause is highly speculative.”⁹⁰

Writing in 2004, Schelhaas thought that her point applied also to the then English law distinction between enforceable liquidated damages clauses and unenforceable penalty clauses.

2.38 On the other hand, Schelhaas suggested that a disadvantage of the Dutch/French system was the general availability of the judicial modification remedy in relation to all penal clauses:

“This results in a situation where a penalty clause is meant to prevent legal procedures in relation to a breach of contract and thus serves legal certainty, but in fact only causes uncertain procedures in relation to the judicial power to modify a penalty clause, since a debtor has a distinct possibility that a court will make use of his [*sic*] power to reduce. This would deprive the penalty clause of its benefits and it is therefore essential that the power to reduce a penalty must be applied reluctantly.”⁹¹

Reform proposals in Civil law jurisdictions

2.39 Reform proposals have been made recently in some of the codified Continental jurisdictions as well as in France. These appear expansive of the judicial power of modification. The Spanish *Código Civil* of 1889, which like its French model starts with a proposition of general enforceability, contains a provision for judicial modification of penalty clauses, but only where there has been partial performance by the debtor.⁹² Amongst the Proposals (*Propuestas*) of the Comisión General de Codificación is one for the modernisation of the law of obligations and contracts, published in 2009.⁹³ This extends the judicial power to deal equitably (*equitativamente*) with manifestly excessive (*manifiestamente excesivas*) penal clauses and agreed indemnifications which are obviously (*notoriamente*) disproportionate in relation to the damage actually suffered. But otherwise penalties are generally enforceable.⁹⁴ The Swiss Code of Obligations, which has likewise provided since 1912 for the recognition and enforcement of party autonomy in setting the amount of a penalty clause, also gives the court a discretion to reduce penalties that it thinks excessive.⁹⁵ The *Schweizer Obligationenrecht 2020/Code des obligations suisse 2020* project, published in 2013, proposes the conversion of the discretion into a requirement,⁹⁶ but otherwise follows the pattern of the general enforceability of penalty clauses.⁹⁷

⁹⁰ *Ibid* 397.

⁹¹ *Ibid* 398.

⁹² *Código Civil* art 1154. See generally arts 1152-1155.

⁹³ The texts of the Comisión's *propuestas* are accessible at: <https://goo.gl/yBoqtV>.

⁹⁴ See generally Articles 1146-1152 of the *propuesta*.

⁹⁵ Swiss *Obligationenrecht* (OR) arts 160-163, especially art 163(3).

⁹⁶ C Huguenin and R Hilty (eds), *Schweizer Obligationenrecht 2020/Entwurf für einen neuen allgemeinen Teil, Code des obligations suisse 2020/Projet relatif à une nouvelle partie générale* (2013) art 220(1).

⁹⁷ See generally *ibid*, arts 218-220. There are parallel texts in German, French, Italian and English at pp CCXXX-CCXXXIII.

‘Mixed’ jurisdictions

2.40 The jurisdictions with legal traditions of ‘mixing’ Civil law and Common law approaches in private law matters tend in this instance to follow the Civilian approach and so to be broadly in line with the DCFR on the subject, even although they all lie outside Europe. They too recognise the general enforceability of penalties subject to judicial modification. In all the systems surveyed below the law is to be found in either code or legislation.

South Africa

2.41 The Roman-Dutch common law mentioned above was transplanted to South Africa, but the law there is now to be found in the Conventional Penalties Act 1962.⁹⁸ A penalty clause operating on breach of contract is enforceable subject to the power of the court to reduce an excessive penalty. The reduction may be to such extent as the court may consider equitable in the circumstances, if “it appears to the court that such penalty is out of proportion to the prejudice suffered by the creditor”.⁹⁹ In determining what may be considered when deciding whether a penalty is “out of proportion”, it has been judicially stated that:

“... everything that can reasonably be considered to harm or hurt, or be calculated to harm or hurt a creditor in his property, his person, his reputation, his work, his activities, his convenience, his mind, or in any way whatever interferes with his rightful interests as a result of the act or omission of the debtor, must, if it is brought to the notice of the Court, be taken into account by the Court”.¹⁰⁰

It has also been observed that “our courts will not try to measure this [*disproportionality*] with mathematical precision”.¹⁰¹

Louisiana

2.42 Under article 2005 of the Louisiana Civil Code of 1984, parties may stipulate the damages to be recovered in case of non-performance, defective performance, or delay in performance of an obligation. An obligee may demand either the stipulated damages or performance of the principal obligation, but may not demand both unless the damages have been stipulated for mere delay.¹⁰² The stipulated damages may be modified by the court when so manifestly unreasonable as to be contrary to public policy.¹⁰³

Quebec

2.43 Articles 1622-1623 of the Quebec Civil Code of 1994 likewise provide for the enforceability of penal clauses without the creditor having to prove any loss, while also stating that the creditor cannot have both the penalty and specific performance of the contract except where the penalty is incurred for late performance.¹⁰⁴ The amount of the

⁹⁸ See Zimmermann *Law of Obligations* 109-110. The full text of the 1962 Act may be consulted in D Hutchison et al *The Law of Contract in South Africa* (2nd edn 2012) 341-342.

⁹⁹ Conventional Penalties Act 1962 s 3 (SA).

¹⁰⁰ *Van Staden v Central South African Lands and Mines* 1969 (4) SA 349 (W) at 352.

¹⁰¹ Hutchison *Law of Contract in South Africa* 343.

¹⁰² La CC art 2007.

¹⁰³ La CC art 2012.

¹⁰⁴ Quebec CC arts 1622-1623.

stipulated penalty may be reduced if the creditor has benefited from partial performance of the obligation or, more generally, if the clause is abusive.¹⁰⁵

Israel

2.44 Under the heading 'Liquidated Damages', section 15 of the Israeli Contracts (Remedies for Breach of Contract) Law 1970 provides for a power of judicial modification guided by the amount of the creditor's foreseeable damage:

"15. (a) If the parties agreed in advance on the rate of compensation (hereinafter: "**agreed compensation**"), compensation will be as agreed, without proof of damage; however, the court may reduce the compensation if it finds that it was set without any reasonable relation to the damage which could be foreseen, at the time the contract was made, as a probable consequence of the breach."¹⁰⁶

Conclusion

2.45 In words which can also be applied to the mixed jurisdictions apart from Scotland, Barbara Pozzo has usefully summarised the general position revealed by consideration of the Civil law jurisdictions:

"In civil law, ... , the courts cannot circumvent full recognition of contractual penalties and invalidate them; the courts can only modify the contract and interpret the rules on contractual penalties in a purposive way, for example, reducing the amount, while – on the other side – the parties cannot exclude, by agreement, the discretionary power of the courts to modify contractual penalties."¹⁰⁷

¹⁰⁵ Quebec CC art 1623 al 2.

¹⁰⁶ Israeli legislation is accessible at <https://goo.gl/PgVSEP>.

¹⁰⁷ B Pozzo 'The European Law of "Contractual Penalties"' (2015) 23 ERPL 355-384, 360.

Chapter 3 *Cavendish/ParkingEye* and the New Common Law Approach

3.1 Until recently most Common law jurisdictions followed the approach stated by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*, or similar rules.¹ India provided the one major (and rather remarkable) long-standing exception to that general position. Under the Indian Contract Act 1872 no distinction is made between liquidated damages and penalties; instead, penalties are enforceable but subject to a power of the courts to make instead an award of damages not exceeding the amount stipulated, i.e. in effect to reduce the amount of the penalty.²

3.2 But now major developments have occurred in the Common law world: first, in the High Court of Australia, which decided in 2012 in *Andrews v Australia and New Zealand Banking Group Ltd* that the penalties rule might be applied even if there was no breach of contract;³ and second, the decision of the UK Supreme Court in November 2015 in the conjoined cases of *Cavendish Square Holding BV v Talal El Makdessi* and *ParkingEye Limited v Beavis*.⁴ We will first discuss the Australian case as, quite apart from the intrinsic interest of its outcome for the present exercise, the High Court's decision was important background for some of the arguments raised later before the UK Supreme Court. Finally we will look at developments since the UK Supreme Court decision was published, including a further significant decision of the High Court of Australia.⁵

¹ *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79. For Canada: G H L Fridman *The Law of Contract in Canada* (4th edn 1999) pp 809-819; C Bildfell 'Exculpatory Clauses and Liquidated Damages Clauses: Two Sides of the Same Coin?' (2015) 78 Saskatchewan LR 347-377; New Zealand: J Burrows, J Finn and S Todd *Law of Contract in New Zealand* (5th edn 2016) para 21.2.6; USA: Restatement (Second) of Contracts, § 356; Uniform Commercial Code, § 2-718; Singapore: *Max Media FZ LLC v Nimbus Media Pte Ltd* [2010] SGHC 30; Ireland: R Clark *Contract Law in Ireland* (8th edn 2016) paras 19.83-19.103.

² Indian Contract Act 1872, s 74.

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

⁴ *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* [2015] UKSC 67, [2015] 3 WLR 1373. It is also worth noting: (1) the Canadian decision in *Elsley v JG Collins Insurance Agencies Ltd* [1978] 2 SCR 916 which stressed the oppressiveness of a clause as key in assessing it as a penalty (in the case, after a restrictive covenant was considered binding, it then fell to the court to decide whether a clause which required the employee to pay a relatively small sum on breach "as for liquidated damages", was a penalty or a limitation clause; the court found it to be enforceable: "It is now evident that the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression."); (2) the New Zealand decision in *Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd* [2004] 2 NZLR 614, in which a provision in a joint venture agreement that upon breach by A, A would be required to return shares to M, was held not penal. It was argued by A that the provision was a penalty, which was contrary to public policy in New Zealand. However, it was held that the penalties rule was not a matter of public policy (despite having occasionally been described as such) and was merely a narrowly construed rule which had developed in a similar manner to other contractual rules, in order to prevent oppression of individuals. The court further found that the provision merely restored M to their previous position, and therefore was not oppressive. This decision is also significant because generally penalties were thought to have a pecuniary character, yet in this case a transfer of property was involved. In addition, the decision illustrates the reluctance of the courts in New Zealand to interfere with commercial contract terms.

⁵ *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28. See further paras 3.54-3.59 below.

Andrews v Australia and New Zealand Banking Group Ltd

3.3 Prior to this case the Australian courts had generally followed the approach to penalty clauses and liquidated damages to be found in England & Wales and in Scotland.⁶ In *Andrews* the applicants in a representative action challenged certain fees charged to customers by banks as void or unenforceable penalties. The fees, which were charged to customers' accounts, were incurred upon 'honour', 'dishonour', 'over limit' and 'late payment' transactions on retail and business deposit accounts and on consumer and commercial credit card accounts. The judge at first instance held that the 'late payment' fees could be challenged as penalties because customers became liable for them upon a breach of contract (their lateness). But the penalty rule could not be applied to the other fees. The circumstances in which they became payable did not amount to breach of contract. The charges were incurred when accounts became overdrawn, credit limits were exceeded, or the customer attempted transactions that would have these results, but with none of these being events which the customer had an obligation to avoid.⁷

3.4 The High Court of Australia over-ruled this decision. The court engaged in a historical analysis of the penalty rule to show that it began as an equitable doctrine in the Court of Chancery, giving relief against penal bonds under which the amount to be paid far exceeded any direct loss which the creditor had suffered under the principal obligation to which the bond was accessory. This doctrine had been transplanted into the common law even before the unification of common law and equity in England under the Judicature Act 1873. At common law it was indeed limited to breach of contract; but that did not prevent the continued operation elsewhere of equity, in which the penalty doctrine remained of wider scope. In the exercise of the equitable side of its jurisdiction, therefore, the court could take a wider approach, free of any requirement of breach. The High Court then held that the 'honour', 'dishonour', and 'over limit' fees were indeed not charged upon any breach of contract by a customer but that they could still be challenged as penalties on the basis of the court's equitable jurisdiction.

3.5 Given that the High Court was extending the penalties rule beyond clauses becoming operative upon a breach of contract, it was bound to essay a definition of the kinds of clause that might be caught. This was offered:

"In general terms, a stipulation prima facie imposes a penalty on a party ("the first party") if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party. In that sense, the collateral or accessory stipulation is described as being in the nature of a security for and *in terrorem* of the satisfaction of the primary stipulation. If compensation can be made to the second party for the prejudice suffered by failure of the primary stipulation, the collateral stipulation and the penalty are enforced only to the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation."⁸

⁶ See e.g. *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170; *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71, (2005) 224 CLR 656.

⁷ This decision parallels that of Andrew Smith J on the point in the similar English case *Office of Fair Trading v Abbey National plc* [2008] EWHC 875 (Comm). This aspect of the case was not taken further, although it was finally decided in the UK Supreme Court under the then prevailing unfair contract terms legislation (*Office of Fair Trading v Abbey National plc* [2009] UKSC 6; [2010] 1 AC 696).

⁸ [2012] HCA 30 para 10.

That this did not necessarily entail breach of the ‘primary stipulation’ was because payment under penal bonds might be made the subject of a variety of different conditions, of which breach of the primary stipulation was but one.

3.6 The High Court also made some comments about the *Dunlop* case, summarising its effect thus: “the critical issue ... was whether the sum agreed was commensurate with the interest protected by the bargain.”⁹ It also noted that historically in equity:

“... the penalty doctrine is not engaged if the prejudice or damage to the interests of the second party by the failure of the primary stipulation is unsusceptible of evaluation and assessment in money terms. It is the availability of compensation which generates the “equity” upon which the court intervenes; without it, the parties are left to their legal rights and obligations.”

3.7 *Andrews* has been the subject of (mostly adverse) academic discussion in Australia and also in England.¹⁰ Further, although the draft Australian Law of Contract was published in March 2014, it seems not to take account of *Andrews* in its short Article 99, which provides that “[a] term in a contract that requires a specified amount of compensation to be paid *on breach* [emphasis supplied] is enforceable unless the amount *grossly exceeds* [emphasis again supplied] the actual loss caused by the breach”.¹¹ The test of ‘gross excessiveness’ is picked up from the Civil Code of the Russian Federation (1994) and the Contract Law of the People’s Republic of China (1999) as well as the PICC and the DCFR.¹² The first two references reaffirm the widespread acceptance of the ‘gross excessiveness’ test outside the Common law world. Another significant point in the draft Australian law is its starting point in the enforceability of the penalty clause.

Cavendish/ParkingEye

3.8 The rule against penalty clauses in England & Wales was the subject of Law Commission criticism as early as 1975, although the Commission’s work was never brought to the point of a Report and draft Bill.¹³ In the period after the publication of our 1999 Report academic criticism of the law intensified.¹⁴ There were also mounting judicial expressions of dis-satisfaction in England & Wales with the law on penalty clauses.¹⁵ The case of *Cavendish Square Holding BV v Talal El Makdessi* brought this dis-satisfaction to a head.

3.9 In *Cavendish*, M agreed to sell to C a controlling stake in the holding company of the largest advertising and marketing communications group in the Middle East. The contract provided that if M was in breach of certain restrictive covenants against competing activities,

⁹ [2012] HCA 30 para 75.

¹⁰ S Harder ‘The Relevance of Breach to the Applicability of the Rule against Penalties’ (2013) 30 JCL 52-69; J W Carter, W Courtney, E Peden, A Stewart and G J Tolhurst ‘Contractual Penalties: Resurrecting the Equitable Jurisdiction’ (2013) 30 JCL 99-132; E Peel ‘The Rule against Penalties’ (2013) 129 LQR 152-157; P S Davies and P G Turner ‘Relief against Penalties without a Breach of Contract’ (2013) 72 CLJ 20-24.

¹¹ The Draft Law is accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2403603.

¹² *Ibid*, para 37.

¹³ Law Commission Working Paper No 61, Penalty Clauses and Forfeiture of Money Paid (1975).

¹⁴ See e.g. S Rowan ‘For the Recognition of Remedial Terms Agreed Inter Partes’ (2010) 126 LQR 448-475; S Worthington ‘Common Law Values: The Role of Party Autonomy in Private Law’ in A Robertson and M Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (2016), 301-322; H Beale ‘Penalty Clauses in English Law’ (2016) 24 ERPL 353-372. The latter two articles were written before but published after the decision of the UK Supreme Court in *Cavendish/ParkingEye*, and give useful references to preceding literature.

¹⁵ See e.g. *Philips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 BLR 41; *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752; *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2004] 1 CLC 401; *Murray v Leisureplay plc* [2005] IRLR 946.

he would not be entitled to receive the final two instalments of the price to be paid by C (Clause 5.1) and could be required to sell his remaining shares to C, at a price excluding the value of the goodwill of the business (Clause 5.6). M subsequently breached the relevant covenants. When C sought to enforce the covenants in their monetary aspect, M responded with a defence that both were unenforceable penalties, since the sums were not based on any genuine pre-estimate of the loss that C would suffer in the event of breach.

3.10 M's defence was un-successful in the High Court, but this was over-turned in the Court of Appeal. Giving the leading judgment, Christopher Clarke LJ held that "the clauses, taken in the context of the Agreement as a whole, are not genuine pre-estimates of loss. On the contrary they are extravagant and unreasonable." But, he continued, "that is not necessarily conclusive. A commercial justification may mean that a clause which is not a genuine pre-estimate is not penal."¹⁶ The clauses, having therefore been analysed for such commercial justifications as compensation for lost goodwill and effecting a clean and final break between the parties, were found to be nonetheless disproportionate, having as their main aim the deterrence of M from breaking the covenants. They were accordingly unenforceable.

3.11 At much the same time as the *Cavendish* litigation was unfolding, motoring and consumer organisations were running a campaign against certain forms of car park charges, under which a car could be left in a parking facility for a certain period of time free of charge but, after that period had expired, a substantial charge applied. The campaign included the publications of opinions of counsel to the effect that the charge was an unenforceable penalty and also open to successful challenge under the Unfair Terms in Consumer Contracts Regulations 1999 (the then implementation in the United Kingdom of the Unfair Terms Directive 1993).¹⁷

3.12 *ParkingEye Limited v Beavis* was a case brought with the support of the Consumers Association to have these arguments tested in court. The facts were typical. PE managed Riverside Retail Park car park for its owners. Numerous notices, indicating that a failure to comply with a two hour time limit would "result in a Parking Charge of £85", were displayed at the entrance to and throughout the car park. The charge had two main objects: (i) management of efficient use of parking space in the interests of the retail outlets and their users by deterring long-stay or commuter traffic, and (ii) generation of income to fund the scheme. On 15 April 2013, B parked but overstayed the two-hour limit by almost an hour. PE demanded payment of £85.

3.13 The judge at first instance held that a motorist who parks in the car park does so on the terms displayed in the notice. While the parking charge had the characteristics of a penalty, it was commercially justifiable because it was neither improper nor manifestly excessive in amount. It was also held that the undertaking to pay the charge was not an unfair term and was not rendered unenforceable by the 1999 Regulations.¹⁸

¹⁶ [2013] EWCA Civ 1539 para 117.

¹⁷ The RAC Foundation published the opinion of John de Waal QC on 20 February 2015: see <https://goo.gl/La92OT>. Mr de Waal was subsequently counsel for Mr Beavis in the UK Supreme Court. In Scotland the opinion of Mark Lindsay QC was published by Citizens Advice Scotland in July 2015: see Scottish Legal News, July 20, 2015, <http://www.scottishlegal.com/2015/07/20/cas-private-parking-tickets-can-be-challenged-in-court/>. The opinion itself seems to be no longer available on the CAS website.

¹⁸ We are grateful to Bobby Lindsay (Glasgow University) for supplying us with a copy of the first instance judgment.

3.14 This view was upheld by the Court of Appeal, where Moore-Bick LJ remarked that “a simple dichotomy between liquidated damages and penalty is inadequate, because it fails to take into account the fact that some clauses which require payment on breach of a sum which cannot be justified as liquidated damages ... should nonetheless be enforceable because they are not extravagant and unconscionable and are justifiable in other terms.”¹⁹ The judgments in this and the *Cavendish* case thus clearly opened up the question of whether the established law on penalty clauses met modern requirements. Its basis in a distinction between genuine pre-estimates of loss and purely deterrent provisions seemed inconsistent with commercial needs, at least in basing the notion of loss upon what the creditor would recover by way of damages in an action for breach of contract. The law did not seem to attach any significance to whether the contract was a negotiated one, as in the *Cavendish* case, or based on standard un-negotiated terms, as in the *ParkingEye* case. In the latter case, unfair terms law provided an alternative solution; did the law on penalties add anything? Might it be better overall to take an approach based on asking whether a penal clause was justified by legitimate commercial interests other than the recovery of loss through some equivalent to damages?

Cavendish/ParkingEye: abolition denied but Lord Dunedin’s tests de-throned

3.15 The final appeals in both *Cavendish* and *ParkingEye* were conjoined in the UK Supreme Court so that the issues raised in the courts below could be considered together. A larger bench than usual – seven rather than five Justices – was convened, making clear the court’s readiness to undertake a major review of the law. The antecedent *Andrews* case in Australia raised the further question whether a penalty had to result from a breach of contract to be subject to regulation. The claimant/appellant in *Cavendish* went still further, with an audacious argument that the rule against penalties should be abolished altogether, at least in commercial cases. The audacity lay, not in the suggestion that the rule against penalties might be abolished, but in the suggestion that judicial power to change the law could stretch this far.²⁰ The Court dismissed that particular argument, although not on the basis of absence of judicial power to abolish any common law rule or doctrine as distinct from over-ruling specific precedents and reworking established doctrines. Rather the Justices went on the footing that the Law Commissions had made no such recommendation

¹⁹ [2015] EWCA Civ 402, para 14.

²⁰ While the view that judges merely declare and cannot change the law is no longer accepted, the limits of their law-making powers have been much debated, not least by leading members of the judiciary: see e.g. Lord Reid ‘The Judge as Law-maker’ (1972) 12 *Journal of the Society of Public Teachers of Law* 22-29; Lord Mackay of Clashfern ‘Can Judges Change the Law?’ (1987) 73 *Proceedings of the British Academy* 285-308; Sir Anthony Mason ‘The Judge as Law-maker’ (1996) 3 *James Cook University LR* 1-15; Lord Bingham of Cornhill ‘The Judge as Lawmaker: an English Perspective’ in P Rishworth (ed) *The Struggle for Simplicity in the Law: Essays for Lord Cooke of Thorndon* (1997) 3-12 (reprinted in T Bingham *The Business of Judging: Selected Essays and Speeches* (2000) 25-34); Lord Sumption ‘The Limits of Law’ 27th Sultan Azlan Shah Lecture, Kuala Lumpur, 20 November 2013 (accessible at <https://goo.gl/0BpyLY>); Lord Dyson MR ‘Have the Judges Become Too Powerful?’ Bentham Presidential Address, University College London, 12 March 2014 (accessible at <https://goo.gl/akp82N>); Lady Hale ‘Legislation or Judicial Law Reform: Where Should Judges Fear to Tread?’ Society of Legal Scholars Annual Conference 7 September 2016 (accessible at <https://goo.gl/Lqjhe4>). The declaratory theory is powerfully defended and reworked in A Beever ‘The Declaratory Theory of Law’ (2013) 33 *OJLS* 421-444. It can be argued persuasively that in *S v HM Advocate* 1989 SLT 469 the High Court did not so much ‘abolish’ the rule that a husband could not rape his wife as declare that such a rule had never existed in Scots law. On the *cessante ratiōne cessante ipsa lex maxim* in Scots law, see *SME* vol 22 ‘Sources of Law (Formal)’ paras 353-354.

when considering the subject previously, and that equivalent rules subsisted in other legal systems with which English law should remain broadly in step.²¹

3.16 The principal judgment in the UK Supreme Court is a joint one by Lords Neuberger and Sumption, with whom Lords Clarke and Carnwath agreed. In general, this judgment can therefore be taken as forming the view of a majority of the court.²² At its heart is a review of Lord Dunedin's speech in *Dunlop* aiming to show that the famous dictum on the penalty/liquidated damages distinction did not provide the ratio of the case, and was not the whole of the law on penalties. In part this was achieved by observing that none of the other judges in the House of Lords, and notably Lord Atkinson, expressly agreed with or approved Lord Dunedin's four tests. But in a key passage Lords Neuberger and Sumption also launched a direct assault upon the authority attributed to the four tests in the fourth of Lord Dunedin's guidelines:

“Lord Dunedin's speech in *Dunlop* achieved the status of a quasi-statutory code in the subsequent case-law. Some of the many decisions on the validity of damages clauses are little more than a detailed exegesis or application of his four tests with a view to discovering whether the clause in issue can be brought within one or more of them. In our view, this is unfortunate. In the first place, Lord Dunedin proposed his four tests not as rules but only as considerations which might prove helpful or even conclusive “if applicable to the case under consideration”. He did not suggest that they were applicable to every case in which the law of penalties was engaged. Second, as Lord Dunedin himself acknowledged, the essential question was whether the clause impugned was ‘unconscionable’ or ‘extravagant’. The four tests are a useful tool for deciding whether these expressions can properly be applied to simple damages clauses in standard contracts. But they are not easily applied to more complex cases.”²³

Lords Mance and Hodge (with whom Lord Toulson agreed) also analysed Lord Dunedin's speech in context and in the light of other authority to find that it could not be treated as definitive for every case.²⁴

3.17 In particular, Lords Neuberger and Sumption took the view that the concepts of ‘genuine pre-estimate of loss’ and ‘deterrence’ as set out by Lord Dunedin are unhelpful. The mere fact that a clause was not a pre-estimate of loss did not without more make it penal, while deterrent provisions were simply ones designed to influence a party's future conduct and in that in no way different from a contractual inducement to perform. But they did also note that in “a straightforward damages clause”, i.e. one attempting to provide specifically for the amount of compensation for a breach of contract, “Lord Dunedin's four tests would usually be perfectly adequate to determine its validity”.²⁵

3.18 Lord Mance too argued that the division between the compensatory and the penal is not absolute. Lord Hodge thought, however, that the test of pre-estimation made sense

²¹ [2015] UKSC 67 paras 36-39 (Lords Neuberger and Sumption, with whom Lord Clarke and Carnwath agreed), 162-168 (Lord Mance), 216-218, 256-267 (Lord Hodge). Lord Toulson agreed rather with Lord Mance and Lord Hodge.

²² Although, as discussed further below, this does not hold good for every aspect of the decision, notably on when the penalty rule is engaged and the application of the law to the clauses in issue in the *Cavendish* case.

²³ [2015] UKSC 67 para 22.

²⁴ See paras 135-142 (Lord Mance); paras 220-221, 242-249 (Lord Hodge).

²⁵ [2015] UKSC 67 para 32.

where a clause is an attempt to fix damages for breach of contract; but not otherwise.²⁶ He later added:

“Where the test is to be applied to a clause fixing the level of damages to be paid on breach, an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach would amount to a penalty and thus be unenforceable.”²⁷

Here he was echoing the first of the four sub-tests set out in Lord Dunedin’s fourth guideline.²⁸ But for Lord Hodge, the test of deterrence set out in the second Dunedin guideline is unhelpful in determining penalty, since many contractual provisions are coercive in nature.²⁹

Cavendish/ParkingEye: the breach requirement; primary and secondary obligations

3.19 The fundamental principle, according to Lords Neuberger and Sumption, is that the penalty rule regulates only the contractual remedy available for the breach of primary contractual obligations, and not the fairness of those primary obligations themselves. By ‘primary obligation’ Lords Neuberger and Sumption therefore mean the obligations of performance in accordance with the contract, while a ‘secondary obligation’ is that which arises upon breach of contract, such as the obligation to pay damages in compensation for the loss caused to the other party by the breach. But the secondary obligations arising upon breach may also be set out in the contract instead of the general law, and this includes penalty clauses.³⁰

3.20 But clauses dealing with the secondary obligations arising on breach fall to be distinguished, in the judgment of Lords Neuberger and Sumption, from a ‘conditional primary obligation’, where “the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum”.³¹ The penalties rule does not apply to such conditional primary obligations. Lords Neuberger and Sumption acknowledge the “capricious consequences of this state of affairs”, and note elsewhere in their judgment that as a result “the application of the penalty rule can still turn on questions of drafting”.³² In their view, however, the difficulties were “mitigated” by the equitable power of the court to look at the substance of the relevant

²⁶ [2015] UKSC 67 para 247.

²⁷ [2015] UKSC 67 para 255.

²⁸ For Lord Dunedin’s guidelines see para 2.6 above.

²⁹ [2015] UKSC 67 para 248.

³⁰ [2015] UKSC 67 para 13. The distinction between primary and secondary obligations in English law goes back at least to the nineteenth-century jurist John Austin (1790-1859) in his posthumously published *Lectures on Jurisprudence* (1st edn 1863; 5th edn 1885) lectures 45-49. The nomenclature was explained by the late Peter Birks: “An obligation is secondary or remedial when the event by which it is triggered is the breach of another, pre-existing obligation. Obligations born of such events stand in a fixed temporal and logical relationship to the anterior obligations which they protect. They are dependent and subsequent. That explains ‘secondary’. By contrast primary obligations are those which lack these properties. The events which bring them into being are not breaches of other obligations. Consequently they neither suppose the anterior existence of, nor function as remedies for, any other obligation” (‘Obligations: One Tier or Two?’, in P G Stein and A D E Lewis (eds) *Studies in Justinian’s Institutes in memory of J A C Thomas* (1983), 21). The distinction was previously revived and deployed by Lord Diplock in the twentieth century, in cases such as *Moschi v Lep Air Services Ltd* [1973] AC 331 and *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 826: see further B Dickson ‘The Contribution of Lord Diplock to the General Law of Contract’ (1989) 9 OJLS 441-462, especially at 448-51 and 453-61. Dickson notes the possible Continental origins of the distinction: see also B Rudden ‘Correspondence’ (1990) 10 OJLS 288; P Birks ‘Rights, Wrongs and Remedies’ (2000) 20 OJLS 1-37 at 4-6.

³¹ [2015] UKSC 67 para 14.

³² [2015] UKSC 67 paras 15, 43.

term rather than its form or its labelling by the parties. A speech of Lord Radcliffe in *Campbell Discount Ltd v Bridge* was quoted: “[t]he intention of the parties themselves” (“by which,” Lords Neuberger and Sumption interjected, “he clearly meant the intention as expressed in the agreement”) “is never conclusive and may be overruled or ignored if the court considers that even its clear expression does not represent ‘the real nature of the transaction’ or what ‘in truth’ it is taken to be.”³³

3.21 Lords Neuberger and Sumption firmly rejected the argument in *Andrews* that the penalty rule can apply in cases where the clause was not triggered by breach. This was based on historical error, the absence of post-1873 authority on the equitable rule, difficulty of application, and (perhaps above all) uncertainty of scope as between the primary obligations of performance and the secondary obligations arising only upon breach of the former:

“[T]he High Court’s decision does not address the major legal and commercial implications of transforming a rule for controlling remedies for breach of contract into a jurisdiction to review the content of the substantive obligations which the parties have agreed. Modern contracts contain a very great variety of contingent obligations. Many of them are contingent on the way that the parties choose to perform the contract. There are provisions for termination upon insolvency, contractual payments due on the exercise of an option to terminate, break-fees chargeable on the early repayment of a loan or the closing out of futures contracts in the financial or commodity markets, provisions for variable payments dependent on the standard or speed of performance and ‘take or pay’ provisions in long-term oil and gas purchase contracts, to take only some of the more familiar types of clause. The potential assimilation of all of these to clauses imposing penal remedies for breach of contract would represent the expansion of the courts’ supervisory jurisdiction into a new territory of uncertain boundaries, which has hitherto been treated as wholly governed by mutual agreement.”³⁴

3.22 Lord Mance however did not advance any developed view on the breach point, simply saying that he did “not see the distinction between situations of breach and non-breach as being without logical or rational underpinning”.³⁵ But Lord Hodge agreed that the scope of the penalty doctrine should not be judicially extended in either English or Scots law beyond the case of the clause made operative by a party’s breach of contract: “[s]uch an innovation would, if desirable, require legislation.”³⁶ For both Lords Mance and Hodge, therefore, a clause operative only after breach remained the starting point for the application of the penalties rule. Thereafter the questions were whether the clause related to a legitimate interest of the innocent party and whether nonetheless it was extravagant, exorbitant or unconscionable in relation to that interest.³⁷ Here, for Lord Mance, “the extent to

³³ [2015] UKSC 67 para 15, quoting *Campbell Discount Co Ltd v Bridge* [1962] AC 600 per Lord Radcliffe at 622. Also cited here is *Street v Mountford* [1985] AC 809 per Lord Templeman at 819.

³⁴ [2015] UKSC 67 para 42. For an example of a ‘take or pay’ clause, see *M&J Polymers Ltd v Imerys Minerals Ltd* [2008] EWHC 344 (Comm), which concerned a contract for the continuous supply of chemicals with a clause whereby the buyers agreed to pay a minimum amount monthly even if they did not order anything from the supplier for that month (‘take or pay’). The buyers attempted to terminate the contract before the end of the three-year period during which the contract was to run because they claimed that the products were not fit for purpose and refused to pay, alleging that the clause was a penalty. This was rejected by the court, which held that the clause was not penal and was commercially justifiable. In coming to this decision, the court took account of the comparable bargaining power of the parties and the lack of an oppressive aspect to the clause.

³⁵ [2015] UKSC 67 para 130.

³⁶ [2015] UKSC 67 para 241.

³⁷ [2015] UKSC 67 paras 152 (Lord Mance), 255 (Lord Hodge).

which the parties were negotiating at arm's length and had every opportunity to appreciate what they were agreeing must at least be a relevant factor".³⁸

Cavendish/ParkingEye: the true test of penalty; legitimate interests

3.23 The true test of a penalty clause, according to Lords Neuberger and Sumption, is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker 'out of all proportion' to any 'legitimate interest' of the innocent party in the enforcement of a primary obligation.³⁹ In their general remarks on the law (as distinct from its application in the cases before them), Lords Neuberger and Sumption did not dwell upon what might constitute a legitimate interest of a party in the enforcement of a primary obligation. They were clear that there can be "no proper interest in simply punishing the defaulter."⁴⁰ Compensation for loss arising from breach is one example of a legitimate interest. "In the case of a straightforward damages clause," they said, "that interest will rarely extend beyond compensation for breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity."⁴¹ But compensation is not the only legitimate interest, as illustrated by the *Dunlop* case itself and more recent decisions on "commercial justifications". Otherwise, "[i]n a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate."⁴²

3.24 Lord Mance added to this, basing himself upon decisions from the early twentieth century on to recent times:

"There may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden. The maintenance of a system of trade, which only functions if all trading partners adhere to it ..., may itself be viewed in this light; so can terms of settlement which provide on default for payment of costs which a party was prepared to forego if the settlement was honoured ...; likewise, also the revision of financial terms to match circumstances disclosed or brought about by a breach"⁴³

3.25 Lord Hodge offered a distinct approach. First, he stated that the penalties rule is founded on public policy. "[T]he public policy is that the courts will not enforce a stipulation for punishment for breach of contract."⁴⁴ From this he further concluded that the "current form" of the law "is of more significance than its historical development".⁴⁵ In making its "value judgment" on the exorbitance or unconscionability of a term, the court takes account of the legitimate interests, "commercial or otherwise", which the innocent party is seeking to protect. He went on:

³⁸ [2015] UKSC 67 para 152.

³⁹ [2015] UKSC 67 para 32. At para 29 Lords Neuberger and Sumption appear to derive the phrase 'legitimate interest' from a well-known dictum of Lord Reid in *White & Carter (Councils) Ltd v McGregor* 1962 SC (HL) 1 at 14: "It may well be that, if it can be shown that a person has no legitimate interest, *financial or otherwise* [emphasis supplied], in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself."

⁴⁰ [2015] UKSC 67 para 32.

⁴¹ [2015] UKSC 67 para 32.

⁴² [2015] UKSC 67 para 35.

⁴³ [2015] UKSC para 152 (citations omitted).

⁴⁴ [2015] UKSC 67 para 243.

⁴⁵ [2015] UKSC 67 para 250.

“Where the obligation which has been breached is to pay money on a certain date, the innocent party’s interests are normally fully served by the payment of the stipulated sum together with interest and the costs of recovery. More complex questions arise where there is an obligation to perform by a certain date, such as the construction of the torpedo boats in *Clydebank Engineering*, as the assessment of the loss suffered by the innocent party may often be difficult and parties may have an interest in fixing the level of compensation in advance to avoid the necessity of an expensive trial. In Scots law a distinction has also been drawn between the breach of an obligation to perform some act and the wilful breach of a prohibition; in the latter circumstance the court is less inclined to treat a harsh contractual remedy as unconscionable.”⁴⁶

3.26 In sum, the judgments seem to be consistent in saying that the innocent party must have a legitimate interest in imposing the clause, one such being in compensation for losses caused by a breach. In such cases, the pre-estimation of loss is still an available test for enforceability. Avoidance of litigation over breach is another legitimate interest, especially where there is difficulty in predicting what the loss from breach will be. Other commercial interests beyond compensation for loss have been recognised as legitimate. Genuinely negotiated terms are likely to show the parties’ acceptance that the interests protected thereunder are legitimate and the protection given not beyond the bounds that the law imposes. But the mark may be over-stepped even when the protected interest is legitimate: there can be extravagant, exorbitant or unconscionable levels of protection in such cases.

Cavendish/ParkingEye: form of penalty

3.27 The judgments also dwelled at some length on the different forms that might be taken by a penalty for breach. While the typical clause stipulates payment of a sum of money by the contract-breaker to the innocent party, this is not the only kind of sanction to which the penalties rule applies. It also applies to obligations on the contract-breaker to transfer assets to the other party for nothing or under value, or clauses where, following a party’s breach of contract, it forfeits a deposit already paid to the other.⁴⁷

3.28 Lords Neuberger and Sumption did not think, however, that a term disentitling the contract-breaker from receiving a sum of money otherwise due from the other party was always a penalty.⁴⁸ Lord Mance in contrast noted that the penalties rule had been applied to terms authorising the withholding of moneys otherwise due to the party in breach.⁴⁹ He also held that the rule applied to terms providing for the forfeiture of sums lodged with the other party or a third party as security for performance and release-back in stages as the contract work was completed; and to terms stipulating for the transfer of property from the contract-breaker to the other party.⁵⁰

3.29 Lord Hodge thought that all the terms discussed by his colleagues could be challenged under the penalties rule.⁵¹ From the point of view of Scots law, however, this involved one significant development: the forfeiture of a deposit, hitherto a term not subject

⁴⁶ [2015] UKSC 67 para 249. The final sentence is followed by citation of, and quotation from, *Forrest & Barr v Henderson, Coulborn & Co* (1869) 8 M 187.

⁴⁷ [2015] UKSC 67 para 16 (Lords Neuberger and Sumption).

⁴⁸ [2015] UKSC 67 para 73.

⁴⁹ [2015] UKSC 67 para 154-155.

⁵⁰ [2015] UKSC 67 paras 156-159.

⁵¹ [2015] UKSC 67 paras 222-238.

to the penalties rule in Scotland, could be so subject.⁵² Lord Hodge noted that the law in England and other Common law jurisdictions had moved from a similar position to one where only a reasonable deposit might be forfeited, with the factors to be considered including customary norms in the relevant market.⁵³ Since the established Scottish authorities had followed English law, he thought there was “no reason why it should not adopt the modern approach of excluding only reasonable deposits from the rule against penalties”.⁵⁴ Further, “where the stipulated deposit exceeds the percentage set by long established practice the vendor must show special circumstances to justify that deposit if it is not to be treated as an unenforceable penalty.”⁵⁵

Cavendish/ParkingEye: forfeiture of deposits; unenforceability and judicial modification

3.30 The English members of the court differed – or at least did not fully agree – on one question arising from subjecting forfeiture of deposits to the penalties rule. There is authority in England & Wales that a term providing for retention of instalments paid under a contract is not subject to the penalties rule but falls instead under a different form of restitutionary equitable relief from forfeiture; likewise for terms making transfers of proprietary interest or proprietary or possessory right subject to revocation or determination on breach.⁵⁶ Lords Neuberger and Sumption did not think it necessary or appropriate to pronounce on whether a term could be capable of review under both the penalties and the forfeiture rules.⁵⁷ Lord Mance, however, was clear that this was “both logical and correct in principle”, the two rules having distinct functions and being operative at different points and with different effects.⁵⁸ Whereas the penalties rule sanctions penal clauses by unenforceability, the forfeiture rule applies to non-penal clauses and relief is only granted on the basis that the breach is rectified by performance. “Consideration whether a clause is penal occurs necessarily as a preliminary to considering whether it should be enforced, or whether relief should be granted against forfeiture.”⁵⁹ Lord Hodge in effect agreed with Lord Mance’s view of English law in this aspect (to which, of course, there is no real parallel in Scots law).⁶⁰

3.31 The issue was focused by differing views about the decision of the Court of Appeal in *Jobson v Johnson*.⁶¹ This was the case generally accepted in England & Wales as authority for the proposition that a term providing for a transfer of property from contract-breaker to the other party is subject to the penalties rule. The problem lies in the order made by the Court of Appeal, having concluded that the term in question was a penalty. Rather than simply declaring the clause void or unenforceable, and leaving the innocent party to whatever other

⁵² [2015] UKSC 67 paras 234-238. For the previous authorities see *Commercial Bank of Scotland Ltd v Beal* (1890) 18 R 80; *Roberts & Cooper v Salvesen & Co* 1918 SC 794; *Zemhunt (Holdings) Ltd v Control Securities plc* 1992 SC 58. The authorities were applied in *Agri Energy v McCallion* [2014] CSOH 13.

⁵³ Lord Hodge refers to *Wallis v Smith* (1882) 21 Ch D 243; *Stockloser v Johnson* [1954] 1 QB 476; *Linggi Plantations Ltd v Jagatheesan* [1972] 1 MLJ 89 (JCPC, Malaysia); *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573 (JCPC, Jamaica); and *Polyset Ltd v Panhandat Ltd* (2002) 5 HKCFAR 234 (Hong Kong).

⁵⁴ [2015] UKSC 67 para 237.

⁵⁵ [2015] UKSC 67 para 238.

⁵⁶ See judgment of Lords Neuberger and Sumption at [2015] UKSC 67 paras 16-17.

⁵⁷ [2015] UKSC 67 para 18.

⁵⁸ [2015] UKSC paras 160-161.

⁵⁹ [2015] UKSC 67 para 160.

⁶⁰ [2015] UKSC 67 paras 229-230. On equitable relief from forfeiture in Scots law, see McBryde *Contract* para 22.163-22.164 (citing in particular the sheriff court case of *Reid v Campbell* 1958 SLT (Sh Ct) 45, which has “such a startling result that the soundness of the decision must be doubted”; after *Cavendish* the case can probably be taken as wrongly decided.)

⁶¹ *Jobson v Johnson* [1989] 1 WLR 1026 (CA).

remedies it might have to enforce the contract, the court held that in equity a penalty was enforceable *pro tanto*, that is, to the extent of any actual loss incurred as a result of the breach. The vendor of the property that would have been re-transferred to him under the penalty clause (shares) was offered instead a choice between two remedies: (i) specific performance of the penalty clause, conditional upon it being ascertained that this would not over-compensate him for the purchaser's breach of contract (non-payment of outstanding instalments of the price); or (ii) an order for sale of the property by the court, with the proceeds being used first to pay the vendor the outstanding instalments plus interest, with the balance then going to the purchaser.

3.32 Lords Neuberger and Sumption declared that in this respect *Jobson v Johnson* was “wrongly decided”. Treating penal clauses as partly enforceable on a discretionary basis dependent on the circumstances at the time of breach was contrary to consistent contemporary authority. Refusing to enforce the transfer unless the vendor agreed to vary the effect of the clause was to rewrite the parties’ contract. The retransfer obligation was purely personal and could not be treated as though it were an equitable mortgage. The Court of Appeal was treating the term as though it were a forfeiture subject to equitable relief rather than as a penalty.⁶² Lord Mance’s argument about the relation between the penalty and forfeiture rules does not seem to address these points specifically.⁶³ Lord Hodge simply agreed with Lord Neuberger and Sumption that the order made in *Jobson v Johnson* was “incorrect in so far as it modified a penalty clause” and “should be overruled”.⁶⁴ Overall, it seems clear that the Supreme Court was of the view that in general in English law the courts have no power to modify a clause found to be penal; it is simply unenforceable, and the parties are then left to whatever other remedies may be open to them in the circumstances of the case.

3.33 Lord Hodge noted that in Scots law, by contrast with English law, the Court of Session enjoys a power to modify or mitigate penalty clauses at common law in addition to the statutory power conferred by the Debts Securities (Scotland) Act 1856.⁶⁵ Later in his judgment, he added this:

“In Scots law the statutory power of the court to modify a penalty ... does not extend to a penalty in support of a primary obligation other than for payment of a sum of money. If there is in Scots law a residual common law power of modification of penalties in support of primary obligations such as to supply goods or services ... I do not see how the power of abatement can extend to modifying the price of a compulsorily transferred asset.”⁶⁶

3.34 The “If” at the outset of the second sentence of Lord Hodge’s dictum seems misplaced, given the relatively extensive pre-1900 authority for the power and the legal position that the common law cannot fall into desuetude.⁶⁷ As Lord Hamilton pointed out in *Wirral Borough Council v Currys Group plc* (cited earlier by Lord Hodge),⁶⁸ at least two of the main

⁶² [2015] UKSC 67 para 87.

⁶³ Note however [2015] UKSC 67 para 186, where Lord Mance finds it unnecessary to take a view on the order granted in *Jobson v Johnson* for the purpose of ruling in the case before him.

⁶⁴ [2015] UKSC 67 para 283 (see also para 230).

⁶⁵ [2015] UKSC 67 paras 251-252.

⁶⁶ [2015] UKSC 67 para 283.

⁶⁷ See *McKendrick v Sinclair* 1972 SC (HL) 25 on desuetude of the common law.

⁶⁸ See *Wirral Borough Council v Currys Group plc* 1998 SLT 463, 466-467; and [2015] UKSC 67 para 252.

decisions on the judicial power of modification at common law concerned penalties for breach of performance obligations.⁶⁹ The position is discussed further below in Chapter 5.⁷⁰

Cavendish/ParkingEye: the application of the new rules

3.35 None of the clauses under review in each of the cases was held by the Supreme Court to be an unenforceable penalty clause under the rules thus elaborated. But the ways in which the Justices reached this result varied.

(i) Application in Cavendish

3.36 In the *Cavendish* case, Clause 5.1 was held by Lords Neuberger and Sumption to be a price adjustment clause and not a penalty clause at all. Although C's entitlement to withhold the final two instalments of the price it was due to pay was triggered by M's breach, this was not a secondary provision subject to the penalties rule but a primary obligation. M received consideration for his shares by (amongst other things) observing the restrictive covenants. Full consideration was earned by full performance on his side. Lords Neuberger and Sumption went on, although perhaps they did not need to do so, to consider the legitimate interest of C upheld by Clause 5.1. Whilst the clause had no relationship with the measure of loss attributable to the breach, C had a legitimate interest in the observance of the restrictive covenants, in order to protect the goodwill of the business generally. The goodwill was critical to C and the loyalty of M was critical to the goodwill. The court could not assess the precise value of that obligation or determine how much less C would have paid for the business without the benefit of the restrictive covenants. The parties – “on both sides, sophisticated, successful and experienced commercial people bargaining on equal terms over a long period with expert legal advice”⁷¹ - were the best judges of how it should be reflected in their agreement.

3.37 Consistently with his view that a withholding term could be a penalty clause, Lord Mance held that Clause 5.1 needed scrutiny for penalty but that it protected legitimate interests of C, and as part of “a carefully negotiated agreement between informed and legally advised parties at arm's length”, it could not be seen as “extravagant, exorbitant or unconscionable”.⁷² Lord Hodge thought that the arguments of Lords Neuberger and Sumption were strong ones but then in any event gave six reasons for not considering Clause 5.1 to be penal in nature. He summarised these as being C's very substantial legitimate interest in ensuring the continuing goodwill of the company by ensuring M's loyalty to the covenants, and the commensurability of the penalty with that interest.

3.38 It should be noted that Lord Clarke (who otherwise agreed with Lords Neuberger and Sumption) declared himself to share Lord Hodge's “open mind” on whether or not the penalties rule was engaged by Clause 5.1, while Lord Toulson explicitly agreed with Lords Mance and Hodge on the application of the penalties rule. It is therefore not entirely clear whether the penalties rule was or was not engaged by the withholding provided for by Clause 5.1. Three of the seven judges thought it was not, two that it was, and two others that

⁶⁹ *Craig v McBeath* (1863) 1 M 1020 (obligations of carriage in contract of affreightment); *Dingwall v Burnett* 1912 SC 1097 (obligations to take over and manage a hotel). See also *Johnston v Robertson* (1861) 23 D 646 (late completion of poor house); *Forrest & Barr v Henderson, Coulbourn & Co* (1869) 8 M 187 (delay in purchase and erection of crane).

⁷⁰ See paras 5.27-5.28 below.

⁷¹ [2015] UKSC 67 para 75.

⁷² [2015] UKSC 67 para 181.

it might be. But all were agreed that the clause protected legitimate interests of C, and was not extravagant, exorbitant or unconscionable in amount in relation to those interests. The fact that the clause was negotiated between equal parties was significant in this outcome.

3.39 Lords Neuberger and Sumption applied much the same analysis to Clause 5.6 as to Clause 5.1. It too was a primary obligation in that it gave C an option to buy shares from M, albeit its exercise was conditional upon M's prior breach of covenant. The Justices thought this could not be treated as invalid without rewriting the contract. The price formula was said to be the penal element; if that was struck down, C would still have the option to buy shares without any price mechanism being in place, which made no commercial sense. The price formula was said to be penal because it excluded goodwill from the calculation of the payment price and so did not represent the estimated loss attributable to the breach. But it reflected the reduced consideration which C would have been prepared to pay for the acquisition of the business on the hypothesis that they could not count on the loyalty of M.⁷³

3.40 Lord Mance on the other hand thought that Clause 5.6 involved a post-breach forced transfer of assets not otherwise agreed to be sold under the broken contract and that for no consideration or a consideration not reflecting the value of the assets in question. It was therefore a clause subject to the penalties rule. But it was not penal. There were again legitimate interests for C to protect, especially given that M was released from the restrictions of the covenant and was free to compete as much as he wished. Complete severance of the parties was a natural provision to make in the circumstances, and the forced transfer at a price ignoring any goodwill that might subsist could not be regarded as exorbitant or unconscionable.⁷⁴

3.41 Lord Hodge once again believed that Lords Neuberger and Sumption had put forward strong arguments for treating Clause 5.6 as a primary rather than a secondary obligation. "But if all such clauses were treated as primary obligations, there would be considerable scope for abuse."⁷⁵ He therefore construed the clause as a secondary obligation which, however, he thought justified by C's legitimate interest in protecting its investment against the risk of the sellers acting against the company's interests. Although the price formula was "harsh", it was not a punishment but an encouragement to the sellers to comply with the restrictive covenants. It was not exorbitant: the contract had been negotiated in detail between roughly equal parties with skilled legal advice, and the covenants were not themselves unworkable.⁷⁶

3.42 As already noted, Lord Toulson agreed with Lords Mance and Hodge on the application of the penalties rule in the *Cavendish* case; and a narrow majority on the nature of Clause 5.6 was therefore achieved when Lord Clarke said that he too thought it a secondary obligation.

(ii) Application in ParkingEye

3.43 The outcome in *ParkingEye* can be dealt with much more briefly, since there was a much greater degree of unanimity amongst the Justices in this case. The Court first held that B had a contractual licence to park on terms of the notice posted at the entrance to the car

⁷³ [2015] UKSC 67 paras 79-88.

⁷⁴ [2015] UKSC 67 paras 182-186.

⁷⁵ [2015] UKSC 67 para 280.

⁷⁶ [2015] UKSC 67 paras 279-282.

park, and then that the £85 charge was incurred for contravening the terms of the contractual licence.⁷⁷ The breach requirement being met, the penalty rule was engaged. But the Court was largely in agreement that the £85 charge was not a penalty, although it had a clear deterrent element and was not an attempt to pre-estimate loss caused by over-staying motorists.⁷⁸ Both PE and the owners of the car park had a legitimate interest in charging over-stayers. The owners' interest was in the provision and efficient management of customer parking for retail outlets to ensure the general availability of parking to all customers. PE also had an interest in gaining income from the charge, in order to meet their running costs and to have a profit margin. The charge was neither extravagant nor unconscionable, having regard to practice around the United Kingdom (including the British Parking Association's Code of Practice, which stipulated a maximum charge of £100), and taking into account use of this particular car park and the clear wording and presentation of the notices to customers. PE could not charge whatever it liked, however; its charging policy remained subject to the tests of not being out of all proportion to the legitimate interests involved, extravagant, exorbitant or unconscionable.⁷⁹

3.44 For completeness we briefly summarise the conclusions of the Supreme Court on the unfair contract terms point in the *ParkingEye* decision. Six of the Justices concluded that the charges did not fail the relevant statutory test by creating a significant imbalance against the consumer contrary to the requirements of good faith.⁸⁰ This was, for reasons very similar to those explaining why they did not offend against the penalties rule.⁸¹ P had a legitimate interest in incentivising consumers not to keep their vehicles in the car park beyond the two-hour period. This was an important element in the efficient management of the car park for the wider benefit of consumers using the facility. The charge was not excessive in achieving that objective. The reasonable motorist would have, and often did, agree to charges of this kind and level.

3.45 Lord Toulson dissented on the unfair terms point, arguing in particular that the burden of proof lay on the supplier (i.e. PE) to show that the consumer would have agreed to the charges in individual negotiations on a level basis. PE had not provided sufficient evidence to establish this point.

Case law subsequent to Cavendish/ParkingEye

Scotland

3.46 The first case to apply *Cavendish/ParkingEye* in Scotland is *Gray and others, Petitioners v Braid Group (Holdings) Ltd* (henceforth *Gray v BGHL*).⁸² The case was concerned with the 'relief' which a court might grant under section 996 of the Companies Act

⁷⁷ In Scots law this no doubt amounts to a contract (see R Rennie *Leases* (2015) paras 2.10-2.15 and note also *University of Edinburgh v Onifade* 2005 SLT (Sh Ct) 63). The Supreme Court saw the arrangement as a 'contractual licence', bargained-for gratuitous licences being recognised as enforceable but also freely revocable by the licensor (A S Burrows (ed) *English Private Law* (3rd edn, 2013) para 4.114 ff).

⁷⁸ Lord Toulson, having been the lone outright dissident on the unfair terms dimension of the case (see para 3.45 below), expressed no view on the position: [2015] UKSC 67 para 316.

⁷⁹ [2015] UKSC 67 paras 94-101 (Lords Neuberger and Sumption), 193-199 (Lord Mance), 284-288 (Lord Hodge).

⁸⁰ The relevant legislation at the time was the Unfair Terms in Consumer Contracts Regulations (SI 1999 No 2083). The law is now to be found in Part 2 of the Consumer Rights Act 2015 but its substance has not changed so far as relevant to the *ParkingEye* case.

⁸¹ See discussion in MacQueen & Thomson *Contract* para 7.76.

⁸² *Gray and others, Petitioners v Braid Group (Holdings) Ltd* [2016] CSIH 68.

2006, having found that the affairs of a company (BGHL) had been conducted in a manner that was 'unfairly prejudicial' to the interests of some of its members. The Lord Ordinary (Tyre) had made a share purchase order against the company but had also held that the basis on which the shares in question were to be valued should not be at their market value (some £20,614,000), but at their subscription or par value (£2,444,000). In taking this approach, Lord Tyre had been guided by a provision in the company's Articles of Association (article 6.8.2.2), to the effect that such a valuation was to be used when a shareholder was a 'Bad Leaver'. The petitioner shareholder in this case was a 'Bad Leaver' because he had participated in bribery offences in relation to the company's business.

3.47 Before an Extra Division the petitioner contended on various grounds that the Lord Ordinary had not been entitled to take this approach, in particular because article 6.8.2.2 was an unenforceable penalty clause. This last was a new point that had not been made before Lord Tyre, but the Division allowed it to be taken "in the interests of justice" (Lord Menzies) and because "once raised, it is not an argument that I feel able to ignore simply on the ground that it came late" (Lord Brodie).⁸³ It might perhaps have been said that the argument related to an aspect of public policy which, therefore, the court could not pass by.⁸⁴ The discussion is technically obiter, since the court by a majority upheld Lord Tyre's decision on the grounds upon which he had made it. But it is a discussion in which too the Division differed amongst themselves as to aspects of the outcome.

3.48 The court was unanimous in holding that article 6.8.2.2 was not, in *Cavendish/ParkingEye* terms, a primary or conditional primary obligation. For Lord Menzies (with whom Lord Brodie agreed⁸⁵), this was because the only circumstance in which a Bad Leaver could be compelled to transfer his shares at subscription prices was that party's fraud or gross misconduct, which constituted breach of contract. Article 6.8.2.2 was different from clause 5.1 in the *Cavendish* case, which was about reduction of the price payable for goodwill when the seller took steps that would reduce the value of the goodwill. The article was a mechanism, not for fixing the price of shares being sold, but for determining the consequences of a subsequent default, which might occur many years after the date of the agreement.⁸⁶

3.49 The third judge in the Extra Division, Lord Malcolm, clearly took the same view of article 6.8.2.2's character as a secondary obligation but did not dwell on the reasons why. Instead he focused on the company's protectable interests, noting that the petitioner's conduct "could be predicted to be, and in fact has been highly damaging, both financially and to the reputation of the business".⁸⁷ The Bad Leaver provisions were a "legitimate and proportionate response to the issues and problems likely to arise if and when circumstances justified their implementation."⁸⁸ Lord Brodie agreed, stressing the negotiation of the terms

⁸³ [2016] CSIH 68 paras 79 (Lord Menzies), 105 (Lord Brodie). The third member of the court, Lord Malcolm, said: "[I]t is plain that the reference to the issuing of [the *Cavendish/ParkingEye* decision] was a pretext, not a reason for this argument being raised for the first time in the Inner House. I have considerable sympathy with the proposition that it comes too late, the respondents having been deprived of the opportunity to address it in the evidence" ([2016] CSIH 68 para 123). But he did nonetheless briefly consider the argument.

⁸⁴ *Gloag Contract* p 549.

⁸⁵ [2016] CSIH 68 para 106. Lord Brodie thought, however, that article 6.8.1, which provided for share transfers when a shareholder ceased to be director/employee "for whatever reason", was an example of a conditional primary obligation.

⁸⁶ [2016] CSIH 68 para 82 (Lord Menzies).

⁸⁷ [2016] CSIH 68 para 125.

⁸⁸ [2016] CSIH 68 para 125.

between the parties and that in these circumstances they could be “presumed to be the best judges of what is legitimate in the circumstances”.⁸⁹ He continued:

“I have not found it difficult to accept that BGHL and the signatories of the shareholders’ agreement had an interest in the faithful and diligent performance by each and all of the shareholders of their duties as employees and/or directors of group companies which might properly be protected by something of the nature of differential pricing of their shares in the event of their premature withdrawal from participation in the business of the group, *a fortiori* if the reason for premature withdrawal has been fraud or gross misconduct.”⁹⁰

3.50 Moreover, Lord Brodie went on, the penalty was neither exorbitant nor unconscionable. In essence article 6.8.2.2 required the shareholder to give up his holding and receive back his initial financial stake, which was not unfair. Both he and Lord Malcolm also stressed that the time at which to assess the penalty was at the date of contracting, rather than to take into account the scale of the actual discrepancy between the present value of the shares and what the shareholder would receive for them under the clause.⁹¹

3.51 Lord Menzies, however, disagreed with his fellow judges on whether article 6.8.2.2 was an unenforceable penalty. He accepted that BGHL had a legitimate interest in the proper performance of their duties by employees and directors; but it had an available sanction in its power to remove these people from their posts. “The company [had] no legitimate interest in requiring [the petitioner] to forfeit whatever value has been built into the shareholding since he subscribed for his shares.”⁹² The risk that the company might over-pay for the shares was taken care of by the provision for independent valuation. A difference of £18 million between the fair value and the subscription price was exorbitant and unconscionable even having regard to the company’s interest in the performance of the contract. Lord Menzies cited the nineteenth-century case of *Watson v Noble* in his support, noting that there the court refused to enforce a penalty in the form of a retransfer of property (shares) following breach when it had no evidence that the breach in question had caused the other party any loss.⁹³ He made no reference, however, to the rule about the time at which to assess the penalty.

England & Wales

3.52 We are aware of only two post *Cavendish/ParkingEye* cases in England & Wales. The first, *Richards and Purvis v IP Solutions Group*, is another ‘Bad Leaver’ decision in which May J held that the terms in question (which applied on breach of contract by the shareholder/employee) were “more akin to a primary obligation agreed between parties for distinct commercial reasons to do with a shareholder leaving the Company. ... the price of £1 payable for the aggregate shareholding of a person who is a “Bad Leaver” is simply the agreed price on transfer.” She went on, however, to opine that even if the terms constituted a secondary obligation she saw “nothing unconscionable in an arrangement arrived at between parties dealing at arms’ length with the benefit of extensive expert advice”.⁹⁴

⁸⁹ [2016] CSIH 68 paras 108-109.

⁹⁰ [2016] CSIH 68 para 111.

⁹¹ [2016] CSIH 68 paras 112 (Lord Brodie), 125 (Lord Malcolm).

⁹² [2016] CSIH 68 para 84.

⁹³ *Watson v Noble* (1885) 13 R 347.

⁹⁴ *Richards and Purvis v IP Solutions Group* [2016] EWHC 1835 (QB) para 85.

3.53 The second English case is *Edgeworth Capital (Luxembourg) Sarl v Ramblas Investments BV*.⁹⁵ There the Court of Appeal applied the new tests for penalty clauses to find that an ‘upside fee agreement’ was not a penalty. The fee was payable upon the occurrence of an event – early repayment of a loan – not upon a breach of contract. It therefore could not be challenged as a penalty. Moore-Bick LJ commented that the appeal “raised no point of law of general importance”.⁹⁶ Its only significance for present purposes is such confirmation as it may provide that the new approach will not necessarily lead courts into overturning established contractual arrangements and payment mechanisms.

Australia

3.54 A much more significant case in which *Cavendish/ParkingEye* is discussed has arisen in the High Court of Australia. In *Paciocco v Australia and New Zealand Banking Group Ltd*, decided in July 2016, the High Court rejected the Supreme Court’s criticism of its *Andrews* decision on the prerequisite of a breach of contract before the penalty rule.⁹⁷ The decision focused most upon the test for when a penalty might be struck down, and in this respect the High Court very largely followed and applied *Cavendish/ParkingEye*. The distinction drawn in the *Dunlop* case by Lord Dunedin between a penalty as a payment of money stipulated as *in terrorem* of the offending party and liquidated damages as a genuine covenanted pre-estimate of damage was subjected to detailed analysis by the court, taking account not only of the *Andrews* judgments, but also those of the UK Supreme Court in *Cavendish/ParkingEye*.

3.55 *Paciocco* was about the ‘late payment’ fee in a consumer credit agreement, which *Andrews* had held to be a payment arising upon a breach.⁹⁸ This was, however, held not to be a penalty even although it was admittedly for a sum larger than the direct loss caused to the creditor by any late payment. Kiefel J (with whom French CJ agreed) thought the distinction between penalties and liquidated damages clauses should not be seen as a “limiting rule”:

“It does not mean that if no pre-estimate is made at the time a contract is entered into, as is the case here, a sum stipulated will be a penalty. Nor does it mean that a sum reflecting, or attempting to reflect, other kinds of loss or damage to a party’s interests beyond those directly caused by the breach will be a penalty.”⁹⁹

Kiefel J went on to argue that the rule against penalties was a rule against threats to or punishment of the offending party bearing no relation, or out of all proportion, to the possible damage to or interest of the other party. The extravagance, or exorbitance, or unconscionability, of the penalty described the “plainly excessive nature of the stipulation in comparison with the interest sought to be protected by that stipulation”.¹⁰⁰ But a prior question is, to what interest of the creditor does the stipulation relate? The creditor’s interest in protection from the loss flowing directly from a breach is not the only possible interest.

⁹⁵ [2016] EWCA Civ 412.

⁹⁶ [2016] EWCA Civ 412 para 1.

⁹⁷ *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28. See the remarks of French CJ on the relationship between the English and the Australian common laws and between the High Court and the UK Supreme Court at paras 6-10. Note especially his reference to our 1999 Report at para 10, and his comment: “It may be that in this country statutory law reform offers more promise than debates about the true reading of English legal history.”

⁹⁸ See para 3.3 above.

⁹⁹ [2016] HCA 28 para 30.

¹⁰⁰ [2016] HCA 28 para 34.

Other business or financial interests might also be relevant. In *Dunlop* itself, for example, the interest of the tyre manufacturers in preventing the disorganisation of its business by price undercutting had been accepted (although now it would be illegal as resale price maintenance). Such interests might be difficult to measure precisely in monetary terms.

“But it also needs to be borne in mind that this task is not one which calls for precision. The conclusion to be reached, after all, is whether the sum is ‘out of all proportion’ to the interests said to be damaged in the event of default.”¹⁰¹

3.56 In the particular case, ANZ had interests that went beyond the direct losses incurred through non- or late payment (the latter of which might be picked up by interest charges). ANZ’s interests included its general operational costs, loss provisioning and regulatory capital costs where increased risk of default increases the amount of capital to be held. Taking all of these into account in fixing the late payment fee did not convert that fee into an unenforceable penalty; it could not be said that its amount was excessive in relation to these legitimate interests.

3.57 Gageler J added some helpful explanatory dicta on the interests which might legitimately be protected by way of a penal clause:

“Such an interest of the innocent party in the observance of a principal contractual stipulation need not be an interest in respect of which the offending party would otherwise be compelled to compensate the innocent party at law (or in equity) in the event of non-observance. ...”¹⁰²

“... the fact that the amount of a payment stipulated to be made on breach of contract is set at a level which provides a negative incentive – even a very strong negative incentive – to perform the contract is not enough to justify the conclusion that the stipulation served only to punish... The relevant indicator of punishment lies in the negative incentive to perform being so far out of proportion with the positive interest in performance that the negative incentive amounts to deterrence by threat of punishment.”¹⁰³

Gageler J, therefore, rejected the argument that the description of a penalty as a threat to be enforced *in terrorem* adds nothing to the requisite analysis: “To the contrary, the description captures the essence of the conception to which the whole of the analysis is directed.”¹⁰⁴

3.58 Keane J highlighted the legitimacy of the creditor’s interest in profitability and balanced risk-taking:

“Only in cases where gross disproportion is such as to point to a predominant punitive purpose have agreed payments payable on breach of contract been struck down as penalties. Thus, for example, where that purpose is not discernible because the evaluation and assessment of the loss covered by the agreed payment is ‘very expensive and very difficult ... to calculate precisely’, the penalty rule has been held to have no application. ... [T]he penalty rule is not engaged by a provision which achieves a profit for the promisee at the expense of the promisor. That is because, if the provision is not distinctly punitive in its character, the penalty rule does not operate to displace the parties’ freedom to settle for themselves the contractual

¹⁰¹ [2016] HCA 28 para 57.

¹⁰² [2016] HCA 28 para 159.

¹⁰³ [2016] HCA 28 para 164.

¹⁰⁴ [2016] HCA 28 para 165.

allocation of benefits and burdens and the rights and liabilities following a breach of contract.”¹⁰⁵

“... the level of interest charged by a bank, while reflecting market forces, may also be affected by the extent to which other means are deployed to cover the risks of the provision of financial accommodation and reward the bank for taking those risks. In this way, the rate of interest demanded of each customer might be expected, other things being equal, to be lower because an enforceable promise is taken from each customer to pay a late payment fee. Such a fee serves to reduce the overall risk assumed by the bank in providing the card facility to its mass of customers and to ensure the level of profitability acceptable to the bank’s shareholders.”¹⁰⁶

3.59 Nettle J dissented from the Court’s decision, taking a narrower view of the impact of *Andrews* and *Cavendish* on the Dunedin principles set out in *Dunlop*. For him the approach of asking whether the penalty was incommensurate with, or out of all proportion to, any legitimate interest of the creditor was needed only in more complex cases involving interests incapable of precise or even approximate definition, such as the government interests in the *Clydebank* case. Otherwise, “ordinarily the only legitimate interest of an innocent party in the performance of a primary obligation is in its performance or in some appropriate alternative to performance”,¹⁰⁷ and in such cases the *Dunlop* tests remained applicable. The present case was such an ordinary case, and the stipulated sum being admittedly one which did not take account of what would have been recoverable as ordinary damages for such breaches of contract, it was an unenforceable penalty.

3.60 Finally, as a postscript to *Paciocco*, we may note that the draft Australian Law of Contract published in March 2014, like the DCFR and the PICC, contains no hint of the ‘legitimate interests’ test as an element in the determination of penalty. Nor does it provide for any judicial power to modify an excessive penalty.

Conclusions

3.61 In *Cavendish/ParkingEye* the UK Supreme Court made a radical adjustment to the law on penalties in England & Wales, and most probably in Scotland also.¹⁰⁸ While the law sets its face against the imposition of a punishment of one contracting party by another by way of a penalty clause, it is no longer a general pre-condition of a clause’s enforceability that it be a pre-estimate of the financial loss which the second party will suffer as a result of the conduct for which the penalty is incurred. Instead, the question is whether the clause offers protection for a legitimate interest of the second party that is not extravagant, exorbitant or unconscionable.

3.62 Actual performance of the contract is a legitimate interest for these purposes, so that the penalty may seek to deter non-performance and/or reward performance (or particular ways of performing) by the first party. The conduct falling to be penalised must be a breach of contract, but the second party’s protectable interests can go beyond what would ordinarily be recoverable as damages flowing from that breach. These protectable interests will generally be of a commercial character. Thus, for example, there can be incentivisation for

¹⁰⁵ [2016] HCA 28 para 221.

¹⁰⁶ [2016] HCA 28 para 224.

¹⁰⁷ [2016] HCA 28 para 321.

¹⁰⁸ For a useful ‘snapshot’ view of English law after the *Cavendish/ParkingEye* decision, together with a ‘restatement’ of the rules see A Burrows *A Restatement of the English Law of Contract* (2016) pp 136-142 section 23.

the first party to perform so that for the second party valuable trading goodwill is not lost altogether, efficient business operations are maintained, and profit margins are achieved. It no longer matters that the penalty could apply to a variety of kinds of breach without seeking to differentiate between them.

3.63 The penalty is unenforceable if it is extravagant, exorbitant or unconscionable in relation to these legitimate interests. Where the second party's interests do not go beyond those ordinarily recoverable via the law of damages, i.e. are confined to compensation, a clause going beyond the pre-estimation of loss is perhaps more likely to be seen as penal; but not where the losses are of a kind not lending themselves to pre-estimation. The pre-estimation can validly be of the highest level of damages that could possibly arise from the breach.

3.64 A penalty negotiated between generally equal parties acting with legal advice (as in the *Cavendish* case) is more likely to be upheld; but that does not mean that an un-negotiated clause (as in the *ParkingEye* case) is more likely to be struck down. The judgments otherwise offer little direct guidance on when a penalty is extravagant, exorbitant or unconscionable; it is perhaps not satisfactory that Lord Hodge sees the determination of these questions as a matter of a court's 'value judgment'.¹⁰⁹ This is particularly so from the point of view of a person trying to draft a valid penalty clause.

3.65 The law on penalty clauses also applies to clauses where the penalty is other than payment of a sum of money *after* breach; it can also apply to the forfeiture of sums of money and other property handed over *before* the breach, as well as to clauses entitling the second party post-breach to withhold payments and other property transfers it was due to make to the contract-breaker. But the amount of a forfeitable deposit must, it seems, be 'reasonable', and market norms may be used to determine what is reasonable in this context. In Scotland, the judgment on this point casts doubt on an Outer House decision delivered in 2014, in which Lord Woolman held that the defender's case failed on the basis that under Scots law the rules in regard to penalty clauses do not apply to deposits.¹¹⁰

3.66 While application on breach remains an essential feature of a clause before it can be treated as a penalty (whether or not enforceable), the Supreme Court also introduced into the analysis the concepts of primary and secondary obligations as a way of explaining when the penalty rules do or do not apply. The complication to which the judgment of Lords Neuberger and Sumption gives rise, however, is that in some cases where a clause appears to become operative only after breach (and so on the face of things be a secondary

¹⁰⁹ [2015] UKSC 67 para 249.

¹¹⁰ *Agri Energy v McCallion* [2014] CSOH 13. P entered a contract to purchase D's domestic oil business on 9 October 2009. The contract anticipated that D would be an employee for at least five years following the sale of the business. P was required to make an initial payment of £100,000 and a deferred payment payable at the end of each year from the date of completion. The yearly deferred payments were calculated based on the financial performance of the business, and adjustment of the amount was provided for within the contract. The parties amended the terms of the original sale agreement, which required P to pay the first instalment of the deferred payment, and an advance payment towards years two, three, four and five. D ceased to be involved in P's business from October 2010. Following his departure from the company, D breached the restrictive covenant contained within the contract. P argued that the amended sale agreement allowed him to recover part of the deferred payment from D. The amended sale agreement provided, *inter alia*, that if D breached the restrictive covenant he was required to return the full amount of the advance payment to P and forfeit his right to receive any payments due by P. D argued that this was an unenforceable penalty clause, while P averred that the rules on penalty clauses were not applicable to clauses providing for a forfeiture of money already paid. Lord Woolman held for P, but was not referred to the Court of Appeal judgment in *Talal El Makdessi v Cavendish Square Holdings BV and Team Y&R Holdings Hong Kong Ltd* [2013] EWCA Civ 1539.

obligation in their terms), it may actually be a ‘conditional primary obligation’ – that is, really an obligation of performance which arises on the occurrence of certain conditions that include breach. To such clauses the penalties rule is not applicable in their view. A yet further complication, however, is that the penalties rule may after all be applied if the clause is in substance a penalty.

3.67 The two clauses considered in the *Cavendish* decision were arguably examples of such conditional primary obligations. So too might have been the article in the shareholders’ agreement mentioned by Lord Brodie in *Gray v BGHL Holdings* under which directors or employees who left their posts ‘for whatever reason’ were thereupon to retransfer their shares to the company.¹¹¹ But the article actually under review in that case (the Bad Leaver article) was unanimously held to be a secondary obligation since it could arise only upon serious breach by the director/employee. That however contrasts with the admittedly tentative view of May J in *Richards and Purvis v IP Solutions Group* that a similar clause was a primary obligation. This kind of uncertainty about how to apply the Neuberger/Sumption division of contractual obligations cannot be said to be satisfactory.

3.68 In much of this the position in English (and Scots) law has moved quite close to that set out in the DCFR and in many of the Civil law and ‘mixed’ jurisdictions. Penalty clauses have become much more generally enforceable unless they are clearly ‘out of all proportion’ to the relevant interests of the party seeking to enforce the clause. The Supreme Court’s continuing prerequisite of breach can be fairly readily (although not exactly) matched with the ‘failure of performance’ by which a clause’s character as a penalty is determined under the DCFR and many of the Civil law and ‘mixed’ jurisdictions.

3.69 The major remaining difference in English law is that after the Supreme Court decision there continues to be no judicial power to modify an excessively penal clause. A clause is either enforceable or it is not. If the latter, the second party is left to whatever other remedy may be available to it under the general law. But such a judicial modifying power already exists in Scots law at common law and by statute. The scope of the latter is definitely limited to penalties in support of an obligation to pay money, but whether the common law power, little used in over a century, has a wider ambit is uncertain.

¹¹¹ [2016] CSIH 68.

Chapter 4 Law Reform Options

4.1 We have the impression that the decision of the UK Supreme Court in *Cavendish/ParkingEye* has had a mixed reception in the legal profession, particularly those operating in commercial areas.

4.2 Aspects of the decision have been welcomed. Thus Stuart Murdoch of Burness Paull commented on the firm website:

“This decision limits the scope for challenges to any liquidated damages or other breach clauses unless they are clearly exorbitant. That is helpful for business certainty as it gives parties comfort that the contractual arrangements they put in place are likely to be upheld by the courts.”¹

Linklaters remarked that the decision had made the law on penalties “much clearer and simpler”.² MacFarlanes said that the freedom of contracting parties had been increased, making it “harder for parties to escape from agreements that they freely entered into”.³ Clifford Chance, while regretting that the penalties rule had not been abolished altogether, and being concerned that a wider range of clauses had been brought within the rule’s net, thought nonetheless that the decision had greatly reduced the risk of forfeiture clauses, such as those commonly deployed in Joint Operating Agreements (unincorporated joint ventures), being struck down as penal.⁴ DLA Piper further noted:

“This could make life easier in terms of negotiating delay payments for late delivery of implementations (although these are often predicated as price reductions ...). It may also open the way to more significant ‘pre-determined’ liability payment provisions where it might be difficult to prove close connection to the loss but where the wider significance of the potential breach for the innocent party is justified and needs to be recognised (e.g. around breach of confidentiality provisions).”⁵

4.3 There were also criticisms, however. DWF, having said that the decision provided commercial parties with “relative confidence that their negotiated agreements will be enforced”, went on to observe:

“In particular, the interpretation of what constitutes a proportionate legitimate interest and manoeuvring around the penalty rule on the basis of primary and secondary obligations will undoubtedly cause difficulties. As a result, the increased flexibility of

¹ See <https://goo.gl/9U3Msp>. Note also the same firm’s comment at <https://goo.gl/Cbl8ws>, and its legal briefing at <https://goo.gl/AbJVIM>.

² <https://goo.gl/PNTp5E>.

³ <https://goo.gl/JCna1t>.

⁴ <https://goo.gl/NFqOmK>. Such Joint Operating Agreements are common in the North Sea oil and gas industries: see G W Gordon ‘Production Licensing on the UK Continental Shelf: Ministerial Powers and Controls’ (2015) 4 *LSU Journal of Energy Law and Resources* 75-95, 78-79; S Styles ‘Joint Operating Agreements’ in G W Gordon et al (eds) *Oil and Gas Law: Current Practice and Emerging Trends* (2nd edn 2011).

⁵ <https://www.dlapiper.com/en/uk/insights/publications/2015/11/penalty-clauses-in-commercial-contracts/>.

the true test may in fact hinder commercial negotiations and make it difficult for parties to predict when the penalty rule will apply.”⁶

A number of other firms made similar comments and anticipated further litigation on the topic of legitimate interests. The barrister John Sharples (St John’s Chambers) elaborated the point still further:

“[B]y significantly widening the scope of the court’s task (e.g. ascertaining the nature and extent of a party’s interests and whether they are legitimate) it has made litigation on penalty clauses more expensive and lengthened the amount of court time which will be needed to decide them.”⁷

4.4 Several firms also suggested that the safest way forward henceforth would be to include statements of the interests being protected by the penalty clause in the contract. A number further noted that the penalties rule could still be avoided by drafting the penal clause in a way that did not make breach of contract a pre-condition for the liability to the penalty to arise. Osborne Clark therefore forecast: “a new battleground to be formed around whether provisions within contracts are primary obligations and not secondary, thereby not engaging the doctrine of penalties.”⁸

4.5 Eversheds drew attention to some uncertainty as between the different judgments as to the continuing relevance or not of the concept of ‘pre-estimation of loss’ in deciding whether or not a clause seeking to liquidate damages in advance was a penalty.⁹ In similar vein Watson Farley & Williams commented: “In a case of such importance to commercial parties, it would have been preferable for the judges to have agreed upon a single formulation of the relevant principles, particularly in circumstances where there is (apparently) no dispute in substance.”¹⁰

4.6 Writers in professional journals echo some of these concerns. But William Day of Allen & Overy LLP remarked that:

“Even before this decision, there were only rare sightings of courts declining to enforce clauses owing to their penal nature. In its wake, we may expect such sightings to disappear altogether: the doctrine may thus become de facto extinct, even if it remains de jure alive.”¹¹

Writing of the construction context and liquidated or ascertained damages (LADs), Tom Collins of Weightmans commented that “it is likely that the new test will make it even more difficult for contractors to challenge LAD clauses as penalties”.¹² Giving a lecture in Australia, the former Deputy President of the UK Supreme Court Lord Hope of Craighead argued that an opportunity to reform the law on penalties was not lost in the *Cavendish/ParkingEye* case, and commented:

⁶ <https://goo.gl/aeqzqE>.

⁷ <https://goo.gl/tueVfJ>.

⁸ <https://goo.gl/vV4dKf>.

⁹ <https://goo.gl/CDIOZN>.

¹⁰ <https://goo.gl/NHw3FS>.

¹¹ W Day ‘A Pyrrhic Victory for the Doctrine against Penalties: *Makdessi v Cavendish Square Holding BV*’ [2016] JBL 115-127, 115.

¹² T Collins ‘Liquidated Damages Clauses - Where are We Now?’ (2016) 32 Construction LJ 463-466, 465.

“The merit of the central part of the Neuberger-Sumption test is that it departs from the ancient formulae used in the previous cases and, in starting afresh, it makes it clear that the bar is being set very high.”¹³

4.7 There has also been some academic criticism. Jonathan Morgan of Cambridge University attacked the failure to abolish the penalties rule altogether, and was concerned about the uncertainties of the new approach via legitimate interests and unconscionability. Even if the message that judicial intervention is to be rare is heeded, “a rarely invoked derogation from straightforward enforcement brings disproportionate doubt and delay - for it can be pleaded much more frequently than it is successfully applied.”¹⁴

4.8 Bobby Lindsay of Glasgow Law School thought that the judges’ differing views on the characterisation of Clauses 5.1 and 5.6 of the *Cavendish* agreement as either a primary or secondary obligation “is deeply unhelpful for future cases in which the delineation between primary and secondary obligation may be key.”¹⁵ But he felt that advocates of abolition of the penalties rule as an undue intrusion upon freedom of contract should not be too despondent:

“The retention of the breach limitation and the adoption of a broader approach to the aims and interests that a clause may legitimately safeguard severely attenuates the scope for judicial intervention in the context of agreed remedy clauses. Sophisticated parties, previously able to avoid its operation by flouting the breach limitation, are now also able to insulate clauses by identifying some legitimate objective that they may pursue. So long as the stipulated sum is not outrageous in relation to that interest it is difficult to conceive of a case where a court would intervene.”¹⁶

But neither Dr Morgan nor Mr Lindsay thought that the Supreme Court had been wrong in not following the decision of the High Court of Australia in the *Andrews* case.

4.9 Dr Carmine Conte of Homerton College, Cambridge, while generally welcoming of the decision, argued that the primary/secondary obligation distinction is unworkable. In his view, an obligation is primary if it arises from parties’ consent, secondary if it arises from the general law. In relation to penalty clauses, therefore, it would be better to distinguish between ‘original’ and ‘collateral’ primary obligations, with penalty clauses being in the latter category. Further, he argued that the idea of ‘legitimate interests’ is only workable if limited to possible remedial responses to a breach (i.e. restitution, disgorgement or substitution), which gives a principled way to measure whether or not the penalty is excessive by comparing its outcome with that of the general law. But if the idea of a legitimate interest is wider, no such principles are available and “there is a risk that an intuitive judicial value judgment will replace a principled comparative exercise”. But the real risk is that, there being no principled basis for comparison, the judges will simply always uphold the penalty clause, and there will have been a back-door abolition of the penalties rule.¹⁷

¹³ Lord Hope of Craighead ‘The Law on Penalties – a Wasted Opportunity?’ (2016) 33 JCL 93-107, 105.

¹⁴ J Morgan ‘The Penalty Clause Doctrine: Unlovable but Untouchable’ (2016) 75 CLJ 11-14. Abolition was also favoured by Edwin Peel before *Cavendish/ParkingEye* reached the Supreme Court: E Peel ‘The Rule against Penalties’ (2013) 129 LQR 152-157. Note too A Nicholson ‘Too Entrenched to be Challenged?’ (2016) 22 European Journal of Current Legal Issues (available only online).

¹⁵ B Lindsay ‘Penalty Clauses in the Supreme Court: a Legitimately Interesting Decision?’ (2016) 20 Edin LR 204-210, 209.

¹⁶ *Ibid*, 210.

¹⁷ C Conte ‘The Penalty Rule Revisited’ (2016) 132 LQR 382-388 (quotation at 387).

4.10 James Fisher of the University of Tokyo criticised the policy view that contract clauses defining secondary obligations are more open to judicial control than those defining primary ones: “[p]rima facie, whatever norms justify the principle of freedom of contract apply with equal force to primary and secondary obligations.”¹⁸ Francis Dawson of the University of Auckland was concerned by the way in which the Supreme Court’s decision may enable a party to circumvent the mitigation rules in contract law damages. He also described the penalty test of legitimate interests as “fragile”, with lack of clarity on what evidence is properly admissible on the question. He suggested:

“It would surely have been better to have begun with a bright line test which was premised on the principle that the law’s objective in an award of contract damages is to provide compensation to the innocent party. It would follow from that principle that, when confronted with an agreed damages clause, the law should lend its aid to the enforcement of provisions which seek to provide compensation for the breach and, as a corollary, that the law should withhold its aid to provisions which are not compensatory and which seek greater amounts than a conventional award. Such a test requires comparison to be made between the agreed sum and the amount the common law would ordinarily award for the relevant breach. The comparison is best made *ex post facto* ...”¹⁹

4.11 We have come to the view that, while the direction in which the UK Supreme Court travelled in its *Cavendish/ParkingEye* decision has attracted some support, there is enough significant doubt about its chosen route to justify some discussion of the law’s further reform by legislation. We do not think that anyone wishes to go back to a system under which a clause must be either a liquidated damages clause that genuinely pre-estimates loss or else an unenforceable penalty. That dichotomy is plainly unworkable and inappropriate. But a range of other options remains open, and the rest of this chapter canvasses the possibilities and invites consultees’ views upon them.

(1) Do nothing?

4.12 A first option is to give the *Cavendish/ParkingEye* decision time to bed in and propose no law reform at all at this stage, while keeping the law under review in case of problems. As already indicated in our analysis of the UK Supreme Court judgments, there has been a significant movement of the law in the direction seen as desirable in our 1999 Report. The test for excessive penalty has been narrowed so that it will apply only in exceptional cases, but the range of clauses to which the test can be applied has been extended. The Court’s decision to retain the requirement that to be a controllable penalty the clause has to be triggered by a breach is inconsistent with our previous recommendation; but does provide a means by which not every clause in a contract requiring one of the parties to do something becomes potentially reviewable as a penalty. As we have seen, such a possibility was of serious concern to consultees commenting in the 2010 consultation on our 1999 Report and draft Bill. Further, the position of the Court against a judicial power to modify an excessively penal contract reflects the existing law of England & Wales, and leaves unaffected the existing powers of the Scottish courts under both statute and common law.

¹⁸ J C Fisher ‘Rearticulating the Rule against Penalty Clauses’ [2016] LMCLQ 169-175, at 171.

¹⁹ F Dawson ‘Determining Penalties as a Matter of Construction’ [2016] LMCLQ 207-219, at 219.

4.13 In other respects, there is much to be said in favour of a continuing close alignment of Scots with English law in the context of the single market operating in the United Kingdom. There is too a respectable case for not embarking upon reform until the impact and implications of the Supreme Court's ruling have had the chance to play out in commercial and legal practice. This would allow time to see how some of the more difficult aspects of the decision actually work and how they are handled by the courts. It might be preferable to wait and see, for example, whether Mr Day of *Allen & Overy* is correct in his prediction that the doctrine of penalty clauses will move from being merely an endangered species to one that is to all intents and purposes extinct.

4.14 While doing nothing always has its attractions, the counter-arguments for doing something in this instance may be summarised as follows. The UK Supreme Court has left uncertainty in its wake at least with regard to its highly abstract primary/secondary obligation distinction and the extent to which it may be overcome by considerations of substance over form; its legitimate interests test; and the measurement of the excessiveness/exorbitance/unconscionability of a penalty clause. The Court acknowledged that confining the application of the rule to clauses triggered by breach may encourage drafting for avoidance. That could produce clauses that offend against the public policy against punishment without any possibility of redress for the affected party; hence the Court's affirmation of the relevance of substance over form.²⁰ The uncertainty this leaves could at least be mitigated by a sufficiently well-defined reform expanding control over penalties arising other than upon breach of contract.

4.15 The contrasting outcomes in the cases since the *Cavendish/ParkingEye* decision reflect this uncertainty.²¹ More cases and practical experience will doubtless emerge as the present exercise in law reform itself develops. These can be factored in as they appear during that period, and indeed in the period between any final Report on the subject and its implementation (if any) in the legislature. Further, there is no good reason why Scotland should not take the lead in reforming an area of law currently similar in the jurisdictions of the United Kingdom. There may be an opportunity to generate support for similar reform in England & Wales if the new Scots law provides greater certainty as to its outcomes. Finally, a judicial power of modification might enable courts to produce fair commercial results in appropriate cases, while in Scotland clarification of the scope and reach of the remedy would anyway be useful.

4.16 But in order to test opinion on the need to address the remaining uncertainties and possible gaps in the law we now ask:

2. **Should the decision in *Cavendish Square Holding BV v Talal El Makdessi* and *ParkingEye Limited v Beavis* be left to 'bed in', with the further development of the law and its application being kept under review, but no specific law reform being recommended at this point?**

²⁰ [2015] UKSC 67 paras 43 (Lords Neuberger and Sumption), 130 (Lord Mance).

²¹ See above paras 3.46-3.53

(2) Outright abolition?

4.17 To judge from published reactions of both practitioners and academics, there is a view amongst some stakeholders that in *Cavendish/ParkingEye* the UK Supreme Court passed up a golden opportunity to reform the penalties rule by abolishing it altogether. The Court did not accept an argument that, the law on penalty clauses being judge-made, it could and should be un-made by them as well.

4.18 The basis for the proposal that the rule against penalties be abolished was because in the view of those making the argument it represents an unwarranted and un-necessary interference with the general freedom and sanctity of contract. In commercial cases, parties are generally well-equipped to look after their own interests, and their autonomy should be respected by the law. Where business parties are not of equal bargaining power and use un-negotiated contract terms, the amended Unfair Contract Terms Act 1977 applies to require that these terms be fair and reasonable. In consumer contracts what is now Part 2 of the Consumer Rights Act 2015 protects consumers specifically against excessively penal clauses, and note may also be taken of the protection against extortionate credit bargains under the Consumer Credit Act 1974 as amended. Statute thus deals with the major areas where protective intervention may be required, and the common law should not seek to supplement it.

4.19 As already noted, the counter-arguments put forward by the UK Supreme Court included the point that rules on penalties are found in most western legal systems and modern ‘soft law’ instruments such as the DCFR. To make English law the odd one out in this regard was unattractive (not to mention the difficult question of what the effect of such a decision would have been in Scotland). Further, statutory regulation “is very far from covering the whole field”, notably the protection of small businesses, employees, and professionals against abusive contract terms.²² The amended Unfair Contract Terms Act applies primarily to clauses excluding or limiting liability, not to penalty clauses. The Court also referred to documents produced previously by our English counterparts as well as ourselves as not having recommended abolition; yet it is perhaps fair to say that neither of these documents really canvassed that possibility in a serious way.²³

4.20 Views on the arguments varied in our Advisory Group, but one significant point was that the argument from freedom and sanctity of contract seems largely free of evidence that the penalties rule causes difficulties in reality other than for drafters of contracts trying to produce enforceable clauses and, occasionally, for courts deciding whether or not these efforts have been successful. It was also suggested in the Advisory Group that the regulation of penalties sometimes helped to “rein in outlandish demands when we are at the negotiating stage”.²⁴ There is slightly harder empirical evidence on the non-abolition side of the argument. We noted in Chapter 1 the complaints of the Federation of Small Businesses about the unfair contract terms used by suppliers, with high charges for early termination prominent amongst the terms mentioned.²⁵ Later in this Chapter we will discuss some of the

²² [2015] UKSC 67 para 38 (Lords Neuberger and Sumption).

²³ Note however Law Commission Working Paper No 61, *Penalty Clauses and Forfeiture of Moneys Paid* (1975) paras 27-28.

²⁴ Brenda Scott (Brodies LLP) summarising a comment made by her colleague Alistair McLean: email to the Advisory Group dated 29/09/ 2016.

²⁵ See para 1.15 above.

difficulties arising from the use of penalty clauses in employment contracts.²⁶ We hope that consultees answering the very first question in this Discussion Paper will give us some firmer evidence of difficulties created or met by the rule against penalties, in whatever direction such evidence may tend to point.²⁷

4.21 One further point made against outright abolition is found in our own earlier work on penalty clauses.²⁸ Without some control in place, parties might write substantial penalties into their contracts, the enforceability of which against one of the parties could, in the event of that party's insolvency (and regardless of whether the insolvency was actually the occasion for the penalty being imposed), prejudice the other creditors of that party by reducing the amount of the insolvent estate, whether by the full amount of the penalty or some dividend thereof alongside the insolvent's other creditors. As we remarked in our 1999 Report:

"Potentially, claims made in the insolvency may therefore be out of all proportion to any loss. Indeed they may be extravagant or unconscionable or excessive. This could severely prejudice other creditors and might provide an incentive to draft extortionate provisions ..."²⁹

4.22 The law against gratuitous alienations, unfair and fraudulent preferences, and extortionate credit transactions in insolvency may not be able to do all the necessary work in this area.³⁰ Whether or not a penalty can amount to an alienation or a preference, if it was created outside the statutory time limits for a challenge as such, or (in a common law challenge) before the debtor became insolvent, then the penalties rule is the only mode of attack. Likewise if the penalty in question did not form part of a credit bargain.

4.23 In the *Cavendish/ParkingEye* decision, Lord Hodge remarked that the rule against penalties is based on public policy: "the courts will not enforce a stipulation for punishment for breach of contract."³¹ He cited several Scottish cases in support of this proposition.³² But he distinguished measures of incentivisation and deterrence from punishment, which took place only when the stipulated penalty was extravagant and unconscionable.³³ Lord Hodge did not refer to a relatively recent decision of the New Zealand Court of Appeal taking the view that the rule against penalties is not based on public policy;³⁴ but we agree with him that the rule against penalties must be so founded. Of course, it must also be balanced against other aspects of public policy such as freedom and sanctity of contract. But we think that it would be unwise to favour the latter so much as to displace the former altogether, especially when similar rules and policies are found in most if not all Western legal systems.

4.24 Given, however, that there are clearly stakeholders who even after *Cavendish/ParkingEye* favour outright abolition of the penalties rule, we now think that the question should be put as the most radical of the available law reform options. We have

²⁶ See paras 5.8, 5.13 below.

²⁷ See para 1.16 above for the first question in this Discussion Paper.

²⁸ See paras 2.2-2.4 above.

²⁹ Report 1999, para 4.5.

³⁰ For an overview see Gloag & Henderson paras 46.51, 49.21-49.25.

³¹ [2015] UKSC 67 para 243.

³² See [2015] UKSC 67 paras 251, 253.

³³ See [2015] UKSC 67 para 248.

³⁴ *Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd* [2004] 2 NZLR 614 (see also para 3.2 note 4).

framed it in terms of three distinct possibilities: (1) outright abolition in all cases; (2) abolition in commercial cases only, because the protection provided by the rule is not needed in that context; and (3) abolition in consumer cases only, because other legislation provides appropriate protection in such cases.

3. Should the common law on penalties be abolished (i) outright; or (ii) in its application to contracts between parties all acting in the course of business; or (iii) in its application to consumer contracts?

(3) Abolition and replacement?

4.25 For the remainder of this chapter, the working assumption is that even after *Cavendish/ParkingEye* the rule against penalties requires reform other than outright or partial abolition. It may be made to reflect public policy better, or to find a more suitable balance with the public policy favouring freedom and sanctity of contract. We hope that those who favour outright abolition or no action (at least for the moment) will nonetheless take the time needed to respond to the questions below on more specific and detailed reform of the rule. It may be that consultees will wish to consider the questions on abolition and no action only after considering the reform possibilities set out below.

4.26 In this part of the exercise, we need to face up to the concerns expressed about our 1999 Report and draft Bill in the Scottish Government's 2010 consultation.³⁵ The essence of the criticism then was that the proposals added to uncertainty rather than removing it. In the 1999 Report and the 2010 consultation the chief focus was on when a penalty clause was subject to judicial control making it ultimately unenforceable, albeit tempered by a judicial discretion to modify manifest excess.

4.27 An alternative approach was however proposed in the 2010 consultation by Dr Ross Anderson (then of Glasgow University Law School and now a member of the Ampersand stable in the Faculty of Advocates).³⁶ He made the suggestion that, like the DCFR and a number of the codified systems, our Bill should open with, or at least include, an explicit statement that penalty clauses are generally valid and enforceable. This would make clear that the legislative intent was to make a definite shift of direction from the law at the time – i.e. that a penalty was unenforceable unless it took the form of a genuine pre-estimate of the loss likely to be caused by a breach of contract, in which case it was enforceable.

4.28 As we have developed our thinking in the course of preparing this Discussion Paper we have become increasingly attracted by an approach founded on the starting point of a penalty clause's basic enforceability. It is the underlying trend of the modern case law in the Common law world, and it also informs the codified systems of law as well as the instruments such as the DCFR which form the benchmark in our review of contract law. Under such an approach, there would not have to be an inference of contractual freedom from the proposition that only 'manifestly excessive' penalty clauses could not be enforced. The focus for judicial intervention and control would cease to be the clause and become instead its actual effects: are these, in the phrase we have coined purely for the purposes of

³⁵ See paras 2.21-2.24 above.

³⁶ Dr Anderson's response is accessible at <http://www.gov.scot/Topics/Justice/law/damages/contract/pcresponses>.

this Discussion Paper, ‘excessively penal’, crossing the boundary between legitimate incentivisation for performance and deterrence of non-performance into punishment of the penalty debtor? Further, against a background of general enforceability, the sanction of unenforceability may seem no longer appropriate, even for excessively penal clauses; outside consumer cases (as governed by Part 2 of the Consumer Rights Act 2015), judicial modification of the penalty to remove the excessively penal elements might be the *only* sanction.

4.29 The difficulty has been in determining how the general approach might best be expressed in legislation. A legislative package which talked of ‘penalties’ being enforceable unless excessively penal (or whatever phrase subsequently emerges) might prove highly unattractive to parliamentarians and commentators. Our Advisory Group was concerned by the terminology in which we initially chose to couch our law reform proposals and in particular by the possible circularity, or at least lack of clarity, in speaking of terms enforceable or not as ‘penalty clauses’, but with sanctions against such clauses only arising on their having an ‘excessively penal’ effect. The benefit of such terminology is that for lawyers it relates the reform to a previously known branch of the law referred to as ‘penalties’, sometimes along with the phrase ‘liquidated damages’. But alternative terminology is not easily found. ‘Agreed damages’ is a label sometimes used by the writers of textbooks; but that is a misnomer if the law stretches beyond the provision of a remedy for breach of contract, or extends (as it already does) to non-monetary remedies such as the transfer of property.

4.30 In the light of such considerations, we have reached the provisional view that the best way forward would be, not to declare penalty clauses in general enforceable, but to start with a legislative statement that the common law rule against penalties is abolished. This would have the effect that penalties were no longer unenforceable (or void), i.e. they would be valid and enforceable. But the statutory protection against penalties for consumers under the unfair terms legislation would be unaffected, while liquidated damages clauses, not being penalties, would clearly remain enforceable according to their terms. But the abolition statement would also go on to make clear that the old regime was to be replaced by a much better targeted one, tailored to meet the requirements of public policy, modern business and greater legal certainty.

4.31 Such a clarification of the legislative aim would, we think, be helpful to stakeholders as well as a strong indication for the courts and practitioners should the suggestion become law. Even after the *Cavendish/ParkingEye* decision, which goes a long way in the direction of a basic enforceability approach, there is still some emphasis in the law on the unenforceability of penalties tempered by the possibility that a party’s ‘legitimate interests’ may allow a different result. We have found it very helpful in thinking through the detail of the reform possibilities to use enforceability as the clear starting point. We believe that this will be demonstrated in the paragraphs that follow. In particular, the approach clarifies possible ways forward in defining the kinds of clause to be regulated, the test for excessive penalty, the onus of proof in that regard, and the sanctions for such excessive penalty.

4.32 The approach would also go a long way to alleviating the concerns expressed by respondents to the Scottish Government’s 2010 consultation on our previous draft Bill. The possible issues identified in relation to the Financial Collateral Directive, the recognition of Scotland as a ‘clean’ netting jurisdiction for derivatives contracts by ISDA, and the use of

‘resolutive conditions’ in general would all be met by a basic rule of enforceability unless the penalty imposed went beyond clearly stated boundaries.³⁷

4.33 As already observed, the suggested enforceability approach would leave unaffected the statutory controls of penalty clauses in consumer contracts. But the reform we suggest is not meant to be limited to non-consumer contracts. Instead, as a reform of Scots contract law in general, it will add indirectly to consumer protection: in particular under our suggestions a consumer will be able to seek judicial modification of the penal effects of a clause rather than be limited by the present consumer law to having it declared unenforceable.

4.34 It is also worth saying that the suggested reform would, like the present law, apply in contracts of employment, which may be thought to be like consumer contracts in needing stronger regulation as a result of the parties’ inequality of bargaining power. It is certainly clear that such contracts may include clauses with penal effects against the employee in particular, and that usually the employee will be offered the contract on a ‘take it or leave it’ basis, with little opportunity to negotiate terms or take independent legal advice. This is so even in quite high-value individual employment contracts, we understand.³⁸ Under the present law, the employee is able to challenge the penal effects of clauses only if they operate upon the employee’s breach of contract; but many clauses with such effects do not do so.³⁹

4.35 In the suggested possible reform set out below, the starting point would be that all such clauses, including those arising other than on the employee’s breach, are enforceable (thus favouring the employer). But the employee’s protection would be slightly increased by being able to challenge the excessively penal effects of clauses whether or not they become operative on breach, making them either unenforceable or (in the sanction which we tentatively prefer at this stage) subject to judicial modification. But there is some further balance in that there may be cases where the employer can at least argue that provisions for payments to departing employees are excessively penal for the employer and should therefore be subjected to judicial control.⁴⁰

4.36 We ask accordingly:

4. **Should it be provided that the common law rule against penalties is abolished, to be replaced by a regime directed at regulating specified types of contract terms if they have excessively penal effects?**

³⁷ The clause in the ISDA Master Agreement, being one triggered by breach (see para 2.22 above), continues to be reviewable as a penalty under the *Cavendish/ParkingEye* decision; but we are not aware that in consequence England & Wales (or Scotland) has ceased to be regarded as a ‘clean’ jurisdiction for ISDA purposes. We suspect that this is most probably because the result of any such review now would still be the same as in the *BNP Paribas* case. It is not the susceptibility to challenge but the likely outcome of such challenges if and when made which determines ISDA’s judgement of whether or not a jurisdiction is ‘clean’ for its purposes.

³⁸ We are grateful to Claire Scott (Burness Paull) for helpful discussion on this point.

³⁹ See e.g. *Berg v Blackburn Rovers Football Club & Athletic Plc* [2013] EWHC 1070 (Ch).

⁴⁰ See e.g. *Murray v Leisureplay Plc* [2005] EWCA Civ 963; *Berg v Blackburn Rovers Football Club & Athletic Plc* [2013] EWHC 1070 (Ch).

Chapter 5 A Replacement Penalties Regime

5.1 This Chapter discusses a possible new regime on penalties replacing the rule abolished as proposed in the previous Chapter. In most respects the questions that follow are simply whether, given the validity and enforceability of penalties as the point of departure, the other recommendations of our 1999 Report, treated in a slightly different order and also in the light of the *Cavendish/ParkingEye* decision and the Scottish Government's 2010 consultation, can be re-worked to produce a more certain and satisfactory law. We should stress again, however, that we ourselves are not committed to any particular view at this stage, and that our final approach will be very much shaped by the opinions of consultees.

What kinds of clause should be regulated?

5.2 The first point to make under this heading is that with a statutory abolition of the rule against penalties, this is a question about the contract terms to which the rules against excessive penalty *may* apply.

5.3 In *Cavendish/ParkingEye* the UK Supreme Court held that one defining characteristic of a penalty clause is that it becomes operational upon a breach of contract by the person upon whom the penalty is to be inflicted, albeit subject to an unclear exception for penalties disguised as primary obligations.¹ There would have been greater certainty had it been clearly held that the rule against penalties applied to all clauses the operation of which was predicated upon breach. But the Court's approach is certainly more limited than our 1999 recommendation, which was that the rule ought not to be confined to breach cases. It should rather extend beyond breach to cases where the penalty is due if the promisor fails to perform, or to perform in a particular way, under a contract, or when there is an early termination of a contract.

5.4 In making our recommendation in 1999, we had in mind a number of situations where a party becomes subject to possibly penal sanctions without having first acted in breach of contract. Most of these could be illustrated through case law in which there had been judicial expressions of frustration at the difficulty or impossibility of applying the rule against penalties despite the punitive effects of the clause in question. Most prominent was the hire purchase example, where the hirer exercising a contractual option to terminate may have to pay a charge to do so.² We also drew attention to cases where contracts were terminated on the occurrence of an insolvency event and the insolvent party became due to let property be

¹ See paras 3.19-3.22 above.

² The leading example in the Scottish case law is *Bell Brothers (HP) Ltd v Aitken* 1939 SC 577. See also *Campbell Discount Co Ltd v Bridge* [1961] 1 QB 445, [1962] AC 600; *Mercantile Credit Co Ltd v McLachlan* 1962 SLT (Sh Ct) 58; *Mercantile Credit Co Ltd v Brown* 1960 SLT (Sh Ct) 41. Note that the Consumer Credit Act 1974 s 100(1) now provides that "Where a regulated hire-purchase or regulated conditional sale agreement [i.e. one where the amount of the credit does not exceed £25,000] is terminated under section 99 [debtor's right to terminate] the debtor shall be liable, unless the agreement provides for a smaller payment, or does not provide for any payment, to pay to the creditor the amount (if any) by which one-half of the total price exceeds the aggregate of the sums paid and the sums due in respect of the total price immediately before the termination."

reclaimed by the other party, or to make payments to that party.³ As already noted, unless such claims are subject to possible control as penalties, they may be out of proportion to any harm suffered by the other party and could operate to the prejudice of other creditors of the insolvent person.⁴

5.5 Our intention in all this was not to create some form of control over contract clauses in general, however. Rather it was to distinguish for such treatment contractually imposed “sanctions due on breach or some other abnormal event”.⁵ The draft Bill attached to the Report sought to elaborate this by starting its definition of a penalty clause with breach or early termination as the events by which the penalty was incurred. This was followed by a third head, namely, “failure to do, or to do in a particular way, something provided for in the contract”.⁶

5.6 As a possible example of the ‘failure to do’ category, our previous Discussion Paper on Penalty Clauses gave contracts allowing a party a choice between ways of performing, one or more of which attracts penal consequences, e.g. in a contract with a fixed completion date, a ‘bonus’ for early completion and a price reduction (possibly progressive) for late completion.⁷ We also quoted an example published by Professor Hugh Beale but apparently first formulated by the late Professor Sir John Smith: “a University Hall of Residence wishing to encourage students to pay their fees at the beginning of term could provide that a student has a choice of paying £200 at the beginning of term or £250 at the end.”⁸ Another example is the accelerated payment clause providing that a sum of money payable in instalments becomes immediately payable in full as a lump sum should the debtor choose to do so (which however will not be breach of contract).⁹

5.7 As the recent Australian cases discussed in Chapter 3 suggest,¹⁰ another example of a non-breach penalty is provided by the bank charges cases, where the customer whose account goes into unauthorised overdraft or whose transactions are dishonoured incurs substantial charges or fees without his or her conduct having been a breach of contract.¹¹ On early termination charges, we have already mentioned the survey of the Federation of Small Businesses published in August 2016, in which clauses of that kind were one of the major examples of terms seen as unfair by the businesses surveyed.¹² A further example of an early termination clause not involving breach may be the ‘exit’ clauses or ‘event fees’ in retirement leases for older people under consideration by our colleagues in the Law Commission for England & Wales (although they are not looking at such clauses as

³ *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296 (on voluntary liquidation of company, suppliers of equipment entitled to retake possession and company liable to pay suppliers sum of money); *EFT Commercial Ltd v Security Charge Ltd* 1992 SC 414 (lessees of equipment liable upon appointment of receiver to lessors’ termination of agreement and for all rental payments due in unexpired period of contract).

⁴ See above paras 4.21-4.22.

⁵ Report 1999, para 4.7.

⁶ Penalty Clauses (Scotland) Bill, clause 1(3)(b).

⁷ DP 1997, para 4.16.

⁸ H Beale *Remedies for Breach of Contract* (1980) 63; see also H Beale ‘Penalty Clauses in English Law’ (2016) 24 ERPL 353-372, 359. We do not think that this definition would catch ‘early bird’ or similar price offers for e.g. events or travel bookings, given that these are pre-contractual.

⁹ *SME* vol 15 paras 811-813. Note too the close-out netting agreements discussed in paras 2.21-2.22 and 5.19 note 27.

¹⁰ See above, paras 3.3-3.7, 3.54-3.60.

¹¹ See *Office of Fair Trading v Abbey National plc* [2008] EWHC 875 (Comm) for dismissal of a claim that such a charge was a penalty, on the ground that the charge was incurred upon a breach of contract.

¹² See para 1.15 above.

penalties). Such clauses or fees are triggered by events such as the tenant's sale, sub-lease or even death.¹³

5.8 Our Advisory Group showed us styles of 'Bad Leaver' clauses where the burdens and duties imposed upon the leaver did not arise explicitly on that party's breach: for example, merely because the individual concerned was not taken to be a 'Good Leaver'. So a person who simply retires before normal retirement age, or leaves for health reasons which are not taken to be sufficiently serious to prevent the person from following his normal employment or to prejudice his earning capacity, is a 'Bad Leaver'.¹⁴ Mention was made in *Gray v BGHL* of a 'Bad Leaver' clause which became operative when the employee left "for whatever reason".¹⁵ As one of our advisers remarked, "It would be curious that you could contend [for] a penalty clause following breach of your employment contract but not if you left in accordance with its terms".¹⁶

5.9 It is important to stress again that the aim of our 1999 Report here was simply to bring such terms within the scope of the controls, *not* to say that they are automatically penal and unenforceable. For this present exercise also, that is a matter for the application of the tests of 'excessive penalty' to be discussed later in this Chapter. Our present suggested starting point is rather the general validity and enforceability of terms like the ones just discussed. Under that approach we do not need to consider whether or not they are, in the conceptual scheme favoured by Lords Neuberger and Sumption in the *Cavendish/Parking Eye* case, primary or secondary obligations, or conditional primary obligations. Instead, the question is whether the term operates on breach or early termination without breach, or where a party is given options as to how to perform the contract, with one of the options having a relatively detrimental consequence for the party by comparison with the other.

5.10 We can see however that the language of "failure to do" used in the 1999 Report and draft Bill may not have been quite precise enough to indicate what we thought should be captured by the options example. We think that it would be better to express the issue in slightly more specific language.

5.11 In order to test the matter further, we therefore ask:

- 5. Should a term of a contract be regarded as potentially subject to regulation for penalty only if it becomes operational upon a breach of contract by the party to whom the penalty would be applied?**
- 6. Or should the scope of the regulation be extended to cover also terms:**
 - (a) providing for early termination of the contract and/or**
 - (b) giving a party options between different ways of performing its obligations under the contract but the choice of one has relatively adverse consequences for the party compared to the other?**

¹³ See the relevant project page of the Law Commission for England & Wales, accessible at <https://goo.gl/5gG4u5>.

¹⁴ The style which we were shown was couched in these terms.

¹⁵ See para 3.67 above.

¹⁶ Brenda Scott (Brodies LLP), in an email sent to the Advisory Group on 29/09/16.

Form of penalty

5.12 Our further recommendation in the 1999 Report was that judicial control should apply whatever form the penalty took, be it payment of a sum of money, a forfeiture of money or property, or a transfer of property. This has been supported by the Justices of the Supreme Court in the *Cavendish/ParkingEye* decision.¹⁷ Some (but not all) of them also extended control over withholding payments or other performances due to be made to the party penalised.

5.13 The scope of coverage offered by this approach, especially if the concept of the regulated clause is extended as envisaged in Question 6 above, can be seen through the example of employment contracts. It is quite common in such contracts for there to be provision for repayments by departing employees in respect of such things as training costs, relocation allowances or enhanced maternity pay even if the departure is for reasons other than the employee's breach of contract.¹⁸ Similarly embraced are bonus or other similar types of clause providing for reduction or complete withholding of the bonus or other payments in circumstances not confined to breach by the employee in question.¹⁹ The 'Bad Leaver' cases show employees who were also shareholders being required to sell their shares back to the employer at less than their current market value.²⁰ These clauses would all be within the scope of the new law. But once again, under the suggested rule all such clauses will be valid and fully enforceable unless found to be 'excessively penal' in their effects.

5.14 The suggested rule of enforceability subject to control of 'excessive penalty' would also extend to "resolutive conditions" setting out circumstances upon which a contract will come to an end before full performance, i.e. terminate early, which was a cause of concern in the 2010 consultation. Respondents then explained that such clauses often provide for forfeiture, basing themselves upon the previous non-applicability of the penalties rule to forfeiture clauses in Scots law. The difficulty now, however, is that the *Cavendish/ParkingEye* decision has made it pretty clear that forfeiture clauses *are* subject to the penalties rule in Scotland as well as in England & Wales, albeit (once again) that it will probably be exceptional for such clauses to be struck down as excessively penal. The further point of interest in the *Cavendish/ParkingEye* decision in relation to custom and market practice is that forfeitable deposits should not exceed in value that which is generally recognised in the market place in question as reasonable. So 'custom and practice in the market' will count in assessing whether or not the forfeiture of a deposit falls to be treated as penal. We discuss this further below.²¹

5.15 Another concern in the 2010 consultation was terms of contracts providing for suspension of performance by a party, as distinct from termination of the contract altogether. We note too that in *Cavendish/Parking Eye* Lords Neuberger and Sumption had difficulty with the idea that in general a term providing for withholding performance might be a penalty. In the case before them, for example, Clause 5.1 enabled C to withhold permanently from M the final two instalments of the price it was due to pay following the latter's breach of the

¹⁷ See para 3.27-3.29 above.

¹⁸ See e.g. *Giraud UK Ltd v Smith* [2000] IRLR 763; *Cleeve Link Ltd v Bryla* [2014] ICR 264, UKEAT/440/12.

¹⁹ See e.g. *Agri Energy v McCallion* [2014] CSOH 13.

²⁰ See paras 3.45-3.52. above.

²¹ See paras 5.59-5.60 below.

clause's restrictive covenant. Lords Neuberger and Sumption argued that, although the withholding was triggered by the breach, the clause was providing for price adjustment, and was not within the scope of the penalty rule. But a majority of their colleagues in the Supreme Court thought otherwise, although they then went on to hold unanimously that the sanction in the clause was not penal.

5.16 We think the view of the majority in *Cavendish/Parking Eye* on this question was sound. Suspension of performance (retention) is a common law remedy for breach in Scots law; but the common law remedy is subject to equitable control by the courts.²² This control can be deployed to prevent suspension becoming an 'instrument of abuse' by use otherwise than to secure future performance by the other party; but not to ensure that the performance withheld should bear any very close relation to the value of the performance to be claimed.²³ The basis of suspension in common law therefore does not preclude the possibility that an express suspension term can also be tested as a penalty.

5.17 We also recommended in 1999 that the court be expressly empowered to consider substance rather than form in deciding whether or not a clause came within the scope of the new law.²⁴ This was intended to make it un-necessary to have specific rules to combat drafting devices for the evasion of the controls. Again this approach found favour with the Justices of the Supreme Court in the *Cavendish/ParkingEye* decision.²⁵ But this, it should be noted, was the result of an acceptance that the rule against penalties was confined to breach cases and did not apply to 'conditional primary obligations'. This could be overcome if *in substance* the conditional primary obligation was a penalty. Form was thus not absolutely determinative. We are uncertain, however, that a legislative provision to this effect is needed if the rule is in the form suggested by Question 6 above, which is wider than that favoured in the Supreme Court and less abstract in its formulation.

5.18 Concerns about the expanded coverage of forms of sanction that can be treated as potentially penal should be substantially alleviated by the overall analytical approach which we tentatively prefer, starting with the rule that all these penalties are valid and enforceable. Below we set out the restrictive test for 'excessive penalty' which also seems to be called for.²⁶ Together these may offer sufficient assurance of the certainty and predictability of enforcement that stakeholders seek, while still leaving it possible for the court to intervene in cases of real abuse and oppression.

5.19 Finally, with regard to the issue about Article 6 of the Financial Collateral Directive raised in the 2010 consultation,²⁷ we see no difficulty in suggesting that a revised Penalty

²² Gloag *Contract* p 639; McBryde *Contract* para 20.77(1).

²³ See the opinion of Lord Drummond Young in *McNeill v Aberdeen City Council (No 2)* [2013] CSIH 102, 2014 SC 335, para 30; also *EDI Central Ltd v National Car Parks Ltd* 2011 SLT 75 para 111 (Lord Glennie) (affd on other issues) 2012 SLT 421.

²⁴ Report 1999, paras 6.2-6.6; Recommendation 4; Penalty Clauses (Scotland) Bill cl 1(3)(b).

²⁵ See para 3.20 above.

²⁶ See paras 5.25-5.62 below.

²⁷ For which see paras 2.21 – 2.22 above. Without wishing to labour the point, we entertain some doubts as to the true impact of Article 6 on the present law or on the law proposed in this Chapter. The Article is not directly transposed into the implementing Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003 No 3226) and therefore probably cannot be effectively invoked in litigation between private parties in the UK. It requires Member States to ensure that a 'title transfer financial collateral arrangement' (1) can take effect according to its terms and (2) that if an 'enforcement event' under the arrangement occurs while an obligation to transfer collateral remains outstanding, the obligation may be the subject of a 'close-out netting provision', i.e. may be

Clause Bill include a provision to the effect that its controls do not affect penalties, or indeed controls upon penalties, provided for in other, more specific legislation or the common law.²⁸ An example of specific legislation preventing the imposition of penalties going beyond the loss suffered by a party in consequence of breach is to be found in section 48 of the Agricultural Holdings (Scotland) Act 1991, which provides:

“Notwithstanding any provision to the contrary in a lease of an agricultural holding, the landlord shall not be entitled to recover any sum, by way of higher rent, liquidated damages or otherwise, in consequence of any breach or non-fulfilment of a term or condition of the lease, which is in excess of the damage actually suffered by him in consequence of the breach or non-fulfilment.”

Reference may also be made here to the limits imposed under the Consumer Credit Act 1974 on what a consumer may be charged for the early termination of a regulated hire purchase or conditional sale agreement (i.e. one where the credit does not exceed £25,000): “the debtor shall be liable, unless the agreement provides for a smaller payment, or does not provide for any payment, to pay to the creditor the amount (if any) by which one-half of the total price exceeds the aggregate of the sums paid and the sums due in respect of the total price immediately before the termination.”²⁹

5.20 With all these reassurances in mind on some important points, we accordingly ask:

7. **In the light of the proposed express provision making contractual penalties generally enforceable, do consultees agree that judicial control over contractual terms that are excessively penal in their effects should be possible whatever form the penalty takes (e.g. a payment, a forfeiture, a transfer of property, a withholding of performance otherwise due)? Please explain any disagreement, including that relating to any particular kind of clause.**
8. **Is it un-necessary to empower the court to consider substance rather than form when deciding whether a clause is within the scope of the new rule against ‘excessive penalty’?**

accelerated so as to be immediately due, or terminated and replaced by an obligation to pay the prior obligation’s estimated current value, with both parties’ obligations then set off against each other for payment of the net balance by whichever party has the greater debt (see Article 2(n)). Article 6 appears to be directed against ‘recharacterisation’ of title transfer financial collateral arrangements and in particular of repurchase agreements or ‘repos’ as secured loans; but such recharacterisation is not characteristic of either Scots or English law, which may explain its non-transposition into UK legislation (see Geoffrey Yeowart and Robin Parsons *The Law of Financial Collateral* (2016) paras 6.10-6.15, 6.29, 6.34). As the case of *BNP Paribas v Wockhardt EU Operations (Swiss) AG* [2009] EWHC 3116 (Comm) suggests (see para 2.22 above), close-out netting provisions seem highly unlikely to be struck at by any form of the law on penalties; and such provisions are very likely to be seen as valid in Scots law (see further Yeowart and Parsons *Law of Financial Collateral* para 23.35 (by Hamish Patrick, who makes no reference to the penalties rule). The index to Yeowart and Parsons contains no entry for ‘penalties’ and the *BNP Paribas* decision is not found in its table of cases.

²⁸ An example of legislation authorising the imposition of what might otherwise be seen as a penalty potentially open to challenge is the ‘calling-up’ procedure for a standard security under the Conveyancing and Feudal Reform (Scotland) Act 1970 s 19 and Sch 6, under which the creditor may call for full payment of the outstanding debt within two months, which failing the creditor may exercise its remedies against the debtor’s property.

²⁹ Consumer Credit Act 1974, s 100(1).

9. Do consultees also agree that there should be provision exempting from judicial control penalties which are specifically provided for in other enactments or rules of law?

Irritancies?

5.21 As mentioned in paragraph 2.14 above, the question of whether (i.e. contractually agreed) irritancies in leases should be included in an examination of penalty clauses was debated within the Commission during the preparation of our 1999 Report. It was only by a narrow majority that the Commission decided that such irritancies would be specifically excluded from the scope of penalty clause regulation, and our draft Bill so provided.³⁰ The majority view was that “it would be safer to leave irritancy clauses in leases for separate consideration”, and that the topic should be included in the Commission’s following (sixth) programme of law reform.³¹ We did subsequently produce a Report on Irritancy in Leases of Land, published in 2003, where we set out several recommendations and a draft Bill.³²

5.22 The 2003 Report remains unimplemented. In June 2012 the then Cabinet Secretary for Justice advised the then Convener of the Scottish Parliament’s Justice Committee that in the view of the Scottish Government the best way forward with the Report was “to seek views from key parties” and then “consider if formal steps should be taken to implement the report, or if we should decide not to implement it”.³³ We are not aware of any such steps having yet been taken, nor of what stakeholder opinion is now on the matter.

5.23 Our present view would therefore be that conventional irritancies in leases should continue to be excluded from the proposed new regime against ‘excessive penalty’. Our 2003 Report makes clear, whether or not its specific recommendations are eventually implemented, that this is an area for detailed technical reform, so that the relatively broad brush of making conventional irritancies subject to judicial control only if excessively penal may be unacceptably simplistic. It is anyway likely that, given the regimes which already exist at common law and under the 1985 Act, irritancies would be excluded under the general provision suggested in our previous question.

³⁰ Report 1999, para 5.15; recommendation 3(2); draft Bill cl 1(3)(3)(a).

³¹ Report 1999, para 5.15. The minority view was that “In relation to most leases, particularly where the obligations of landlord and tenant are reasonably balanced, as they would normally be in a commercial lease, or where there is already statutory provision for compensation for tenants’ improvements, the consequences of irritancy would not be manifestly penal” (Report 1999, para 5.15 fn 24). For our Sixth Programme of Law Reform (Scot Law Com No 176, 2000), see <http://www.scotlawcom.gov.uk/files/7912/7989/6662/rep176.pdf>.

³² Report on Irritancy in Leases of Land (Scot Law Com No 191, 2003). The Report recommended an expansion of the scope of the controls over conventional irritancies laid down in the Law Reform (Miscellaneous Provisions) (Scotland) Act 1985, in order to create a unified scheme including all leases of land and not just commercial leases. A distinction was proposed between remediable and non-remediable breaches (as opposed to the existing law, which instead differentiates monetary from non-monetary breaches). With regard to remediable breaches, it was recommended that a landlord should be unable to terminate a lease without having given express written warning to the tenant about the intention to serve a notice of termination, in order to give the tenant the opportunity to remedy the breach. The notice period for monetary breaches proposed was 28 days. We suggested that, when irritancy of a lease is the result of insolvency, a moratorium notice (giving the insolvency practitioner 6 months to assign the lease) be served prior to any notice of termination. For non-remediable breaches, we proposed that irritancy should be permissible on the condition that it was not a disproportionate response to the alleged breach. Our research at the time suggested that legal irritancies are rarely, if ever, used in practice, and we recommended they be abolished.

³³ Letter of 19 June 2012 from Kenny MacAskill MSP, Cabinet Secretary for Justice, to Christine Grahame MSP, Convener, Justice Committee, Scottish Parliament, Annex A eighth bullet point.

5.24 We accordingly ask:

10. Do consultees agree that conventional irritancy clauses should be excluded from the controls against ‘excessive penalty’?

When is a clause excessively penal, and what are the legal effects thereof?

5.25 In the immediately preceding paragraphs we have attempted to explain that a widened definition of penalty clauses taken to be valid and enforceable should be developed along with a narrow test of what will make the effects of a clause excessively penal and subject to the control of the courts. In the discussion that now follows, we offer an assessment of the various possible tests of ‘excessive penalty’. It seems to be generally agreed in policy terms that (apart from the existing consumer protection rules) the test should be one which will apply only to prevent clear abuse of the general freedom to impose penalties under a contract.

5.26 Although it may seem to put the cart before the horse, it is actually of crucial importance to decide first what the consequences of penalty are to be. In the present law, even after the *Cavendish/ParkingEye* decision, the effect of a finding of penalty in the present law is that the clause is unenforceable, and the creditor is sent to its common law remedies, whatever they may be. What precisely otherwise is meant by ‘unenforceability’ is not completely clear: even in *Cavendish/ParkingEye* the Justices talk about voidness and invalidity alongside unenforceability.³⁴ Unenforceability does however fit with the idea that penalty clauses are contrary to public policy, at least when excessively penal.

5.27 Further, in Scotland, how this unenforceability relates to judicial powers to modify the penalty under the common law and statute is really untested water. There is the view that the power is limited to penal obligations arising from non-payment of money.³⁵ The statutory power under the Debts Securities (Scotland) Act 1856 certainly is;³⁶ whether the common law power is so limited is less clear. In *Wirral Borough Council v Currys Group plc*, Lord Hamilton took the obiter view that it extended to penal obligations arising from breach of performance obligations. The limited earlier case law had involved obligations of carriage, construction, and take-over and management of a hotel.³⁷ The *Wirral* case itself, however, was one where the penalty was due when a tenant under a commercial lease failed to pay an instalment of its quarterly rent.

5.28 If the common law power applies to performance as well as payment obligations, either the law is (i) that the penalty is unenforceable and the creditor must claim instead common law damages (even if these turn out to be greater in amount than the sum imposed by the penalty);³⁸ or (ii) that the court modifies the penalty to the amount of the loss for which damages could be claimed.³⁹ The power seems therefore to be one to modify the penalty to

³⁴ [2015] UKSC 67 para 88.

³⁵ See para 3.33 above.

³⁶ See para 2.17 above for the text of the Debts Securities (Scotland) Act 1856 s 5.

³⁷ See *Wirral Borough Council v Currys Group plc* 1998 SLT 463, 466-467. For the earlier cases see para 3.34 and note 69 thereto.

³⁸ As in *Dingwall v Burnett* 1912 SC 1097. See further *SME* vol 15 para 796.

³⁹ *Craig v McBeath* (1863) 1 M 1020, per LJC Inglis at 1022 (“it is a penalty of that kind which we are bound to modify to the actual loss if duly required by the defender to do so”); *SME* vol 15 para 783; McBryde, *Contract*, para 22.172.

the amount of the actual loss suffered through the antecedent breach of contract. The statutory power is likewise to reduce the penalty “so as not to exceed the real and necessary expenses incurred in making the debt effectual”.⁴⁰ In the *Wirral* case Lord Hamilton remitted the case for proof of the landlord’s actual loss.

5.29 If the law were to be adjusted to widen the scope of control beyond terms operative on breach while making clauses with penal effects generally valid and enforceable, then the sanction of unenforceability for excessive penalty might seem rather extreme. A power to modify only terms applying to breach of monetary obligations would certainly be too narrow. Restricting the power to modify to the reduction of the amount of the penalty to the actual recoverable loss would be inapt, and certainly problematic for the creditor placed in that position.

5.30 In this light, the alternative position in the DCFR and the Civil law and ‘mixed’ jurisdictions can be seen as having something to commend it. In varying ways their solution is, not to make the clause with excessively penal effects unenforceable, but instead to render it subject to judicial modification by removal of at least some but not necessarily all of the penal effects. This is certainly more consistent with the basic approach of enforceability. The creditor continues to get a remedy of the kind provided for in the contract rather than having to work out and seek an alternative in the general law. This is especially important in the non-breach clauses, where there may be no remedy at all in the general law. The comments to the DCFR article make the point this way:

“... the court ... should respect the intention of the parties to deter default and therefore should not reduce the award to the actual loss. The court has to fix an intermediate figure.”⁴¹

5.31 Judicial modification is clearly not compatible with a sanction of unenforceability in the sense that the two cannot be cumulated, i.e. work together at the same time. This is an argument, we now tend to think, for having one or the other but not both. We further incline to believe that in general a suitably defined power of judicial modification is a better, more appropriate remedy for ‘excessive penalty’ than what is really the current law’s principal sanction of unenforceability. This perception however deliberately leaves out of account the position of the consumer, against whom a penalty clause is unenforceable where contrary to good faith it creates a significant imbalance between the parties to the detriment of the consumer.⁴² We do not wish to make any change in consumer protection law in this regard, although we have no objection to judicial modification being a further weapon in the consumer’s armoury.

5.32 We will elaborate on the detail of the modification remedy later in this chapter.⁴³ But for the moment we simply ask these inter-connected questions:

11. Should it cease to be possible for a court to declare a clause unenforceable for excessive penalty (apart from consumer cases)?

⁴⁰ Debts Securities (Scotland) Act 1856 s 5.

⁴¹ DCFR III.-3:712 Comment B (p 963).

⁴² Consumer Rights Act 2015 Part 2. See paras 2.28-2.30 above.

⁴³ See paras 5.63-5.68 below.

12. Should the only sanction for the excessive penalty of a clause (apart from consumer cases) be judicial modification?

5.33 Before we go further into the detail of the modification remedy, however, we must first deal with when this remedy (or that of unenforceability, should it survive) will be available and applied instead of simply enforcing the clause.

5.34 Our previously proposed test that the penalty must be ‘manifestly excessive’ received some criticism in the Scottish Government’s 2010 consultation. The Law Society of Scotland, noting that the draft Bill gave “little guidance” on how the phrase was to be interpreted, thought that it seemed to be a lower standard than the ‘grossly excessive’ of the DCFR, and therefore increased the likelihood of challenge. The Committee of Scottish Clearing Bankers thought that ‘manifestly excessive’ might be preferable as a test to ‘genuine pre-estimate’, but:

“... further guidance is required as to what constitutes ‘manifestly excessive’ and, in particular, what factors will be considered in determining whether something is manifestly excessive (e.g. considering a default interest provision or re-banking fee in isolation could lead to a different conclusion to considering the pricing as a whole on a facility, which we expect would have been determined by considering regulatory capital and risk-weighting issues at origination). Without any such guidance, there would be a real lack of certainty in knowing what contractual arrangements a court would give effect to, and what factors the court may think are relevant in making any determination ...”⁴⁴

5.35 The law firm McGrigors also thought ‘manifestly excessive’ without more was “too vague” and noted that, while the courts might eventually formulate a test, in the meantime clients might choose not to make their contracts under Scots law. They too called for statutory guidelines if the test was to be brought in.⁴⁵

5.36 While the civil codes of Continental Europe and the mixed jurisdictions discussed in Chapter 2 are generally content to leave the application of broad general tests to the good sense of their judiciaries, the legislative tradition of the United Kingdom has often taken a more detailed and directive approach in such matters. In that light we agree that it would have been helpful if our previous proposals had given more guidance as to what factors could be taken into account in determining whether or not a penalty could be subject to judicial modification. With the benefit of hindsight, we were optimistic in thinking that the excessively penal effects of a provision in a complex commercial contract could ever be “immediately obvious to anyone considering it”.⁴⁶ We therefore set out some possible guidelines in the immediately following paragraphs.

5.37 The factors which we have identified as at least possibly relevant to the question of ‘excessive penalty’ are drawn from the judgments in the *Cavendish/ParkingEye* decision, the DCFR and other comparative law sources, and other cognate UK legislation such as the Unfair Contract Terms Act 1977 and the Consumer Credit Act 1974. We think that (with one exception⁴⁷) they are equally capable of application to penalty clauses whether or not they

⁴⁴ <https://goo.gl/U0kwMh> .

⁴⁵ <https://goo.gl/4lA9qH> .

⁴⁶ Report 1999, para 3.8.

⁴⁷ See para 5.61 below for this exception.

are triggered by breach; whatever form the penalty may take; and whether or not the remedies for excessive penalty are unenforceability of the clause or judicial modification thereof, or both. The suggested factors may interact and overlap in many cases, or only one may be relevant in a given case. Nor, we think, should the list of factors seek to be in any way exhaustive. But they should be at least suggestive as to what other factors might properly be taken into account.

5.38 The first factor suggested in the DCFR commentary is comparison between the stipulated sum and the actual loss to the creditor resulting from the non-performance and the other circumstances. It needs to be clear that ‘loss’ here extends beyond what would ordinarily be recoverable in a damages claim for breach of contract. The DCFR commentary points out that the court should have regard to “the loss actually suffered by the creditor, as opposed to the loss legally recoverable ...”.⁴⁸ But it is perhaps worth saying that the losses that *are* legally recoverable as damages are at least a pointer in the direction of what may constitute a ‘legitimate interest’ protectable by way of a penalty clause.⁴⁹ We think the argument of Dr Conte (that the idea of ‘legitimate interests’ should be limited to possible remedial responses to a breach (i.e. restitution, disgorgement or substitution) as giving a principled means with which to measure ‘excessive penalty’) cannot be accepted if non-breach clauses are brought within the scope of judicial control and also given that, even under the present law, penalties may take a non-monetary form.⁵⁰ But this is not to say that the recoverability of losses under the general law is an altogether irrelevant consideration in assessing ‘legitimate interests’ and ‘excessive penalty’.

5.39 As we have noted earlier, *Cavendish/ParkingEye* recognises that protectable interests also include the avoidance of litigation and the creditor’s commercial interests, including for example the commercial interest in actual performance by the other party so that valuable trading goodwill is not lost altogether, efficient business operations are maintained, and profit margins achieved.

5.40 We think further that the South African courts have made a useful statement in applying the Conventional Penalties Act 1962 when saying that “everything that can reasonably be considered to harm or hurt, or be calculated to harm or hurt a creditor in his property, his person, his reputation, his work, his activities, his convenience, his mind, or in any way whatever interferes with his rightful interests as a result of the act or omission of the debtor” is relevant in considering whether or not a penalty clause in favour of that creditor should be modified by the court.⁵¹ The ‘harm or hurt’ wording here in particular avoids the inherent possible confusion in speaking of ‘loss’, which may tend to point misleadingly towards the kinds of loss that the law will recognise, in particular in the award of damages for breach of contract.

5.41 Professor Hugh Beale, formerly a Law Commissioner for England & Wales, has in a recent article raised the question of whether a creditor’s legitimate interests may include the losses that will be suffered by a connected third party if the contract is broken or some other

⁴⁸ DCFR III.-3:712 Comment C.

⁴⁹ This however raises a question about the Scots law position on e.g. damages based on the contract-breaker’s gain from a breach of contract, or a non-patrimonial loss caused by breach. See also para 5.41 below.

⁵⁰ See para 4.9 above for Dr Conte’s views.

⁵¹ *Van Staden v Central South African Lands and Mines* 1969 (4) SA 349 (W), 352.

performance-related event occurs.⁵² His thought is prompted by the facts of the *ParkingEye* case, where the owner (as distinct from the operator) of the car park would be adversely affected by breach of the parking contract.⁵³ Since in the general law of contract it is recognised that in some circumstances damages for breach of contract may include losses suffered by a third person who is not party to the contract and who does not have a remedy for the loss it will suffer,⁵⁴ there is no obvious reason why such losses may not be covered by an express penalty.

5.42 The emphasis in the discussion so far is upon the creditor's interest in not suffering loss of some kind. But our Advisory Group raised the possibility of a creditor who wishes to encourage certain kinds of behaviour by others in order to protect or enhance wider societal or environmental goals and who can impose sanctions upon those whose actions tend to defeat these goals. The example given was that of a landowner whose extensive property includes a beauty spot. The owner allows public access and indeed encourages people to come and enjoy the site. Car parking is allowed there but the beauty spot becomes congested with vehicles because people tend to sit there and admire the view for a long time. The landowner creates a system of free parking for a short time only, after which a charge of £50 an hour becomes payable, with the intention being to maximise the public's opportunities to enjoy the view. It is difficult here to see how the amount of the charge can be assessed against any measurable loss to the landowner arising from the congestion at the beauty spot denying some (but not all) members of the public the opportunity to enjoy it as she would wish. But this may be simply to say that such a charge is not really amenable to being regulated by the law against excessive penalties. In any event, if the owner is simply permitting others to be on the land, is there a contract at all?

5.43 Further questions raised in our Advisory Group were (1) whether contracting parties should be encouraged to state in their contracts the interests which they sought to protect by imposing penalties; and (2) whether there are any interests which should be expressly excluded as illegitimate justifications of a penalty apart from the punishment of the penalty-debtor. We have included these amongst the Questions which we ask in this part of the Discussion Paper.⁵⁵

5.44 Finally, the comparison of the stipulated sum and the actual loss raises two further points in relation to earlier discussion: (3) in the model of penalties developed above (and in the *Cavendish/ParkingEye* decision), not every penalty involves the payment of a stipulated sum; and (4) comparison with the actual loss (or harm or hurt) suffered by the creditor necessarily involves looking at circumstances since the making of the contract.

5.45 We tentatively think that (3) might be dealt with by expressing the guideline in terms of comparing the 'stipulated penalty' with the 'actual hurt or harm' to the creditor's 'legitimate interests'.

⁵² Beale 'Penalty Clauses in English Law' 371.

⁵³ It has been suggested in our Advisory Group that the thought could also apply on the *Cavendish* facts, since there the loss of goodwill was the company's rather than of the major shareholder seeking to enforce its contract.

⁵⁴ We discuss this briefly in our Discussion Paper No 157 on Third Party Rights in Contract (2014) paras 3.11-3.14. See also MacQueen and Thomson *Contract* para 6.54-6.56.

⁵⁵ See Question 16 below.

5.46 With regard to (4), we reach an issue which provoked much criticism of our draft Bill in the Scottish Government consultation in 2010. Under the current law a court puts itself, initially at least, in the position of the parties at the time of contracting in assessing whether or not a clause is a penalty or liquidated damages. In our view, however, it is the discredited application of the 'genuine pre-estimate of loss' test for enforceability that makes it logical for the court to take the circumstances at the date of the contract as the starting point. If, instead, the courts are to be asked whether a penalty is 'excessively penal' in a particular case, we think that it would be inappropriate to restrict consideration to the circumstances prevailing at the time at which the contract was made. Provided that the sum payable is not excessively penal in relation to the breach or other triggering event which has in fact occurred, there is no reason why the penalty should not be enforceable.

5.47 In our 1999 Report this was the basis upon which we recommended that the court should be able to take into account all relevant circumstances, including those arising after the formation, in determining whether a penalty is manifestly excessive. We noted that a clear majority of consultees had taken this view in response to our preceding Discussion Paper. The Sheriffs' Association commented that, in their judicial experience, it was almost impossible not to be influenced, to some degree, by the circumstances following completion of the contract, and that it was often frustrating and artificial to be prevented from taking such factors into account. Another commentator noted that such a reform was desirable because what might appear to be excessive at the outset might not turn out to be so excessive once the actual loss was known. Our draft Bill took a permissive approach in its clause 1(4): the courts would have been enabled, rather than required, to look at post-formation circumstances.

5.48 But in the Scottish Government's 2010 consultation, significant doubts about this approach were voiced, in particular by the law firm Dundas & Wilson. They gave the telling example of liquidated damages clauses in PFI/PPP schemes, and the general understanding and acceptance of the pre-estimate test in the context of contracts with a lifespan of 20-25 years. Dundas & Wilson commented:

"Parties have also been comfortable with the knowledge that fluctuations in the property market which might influence the actual loss which will be incurred as a result of a breach, are irrelevant. In the current climate a party in a building or property transaction claiming fixed damages will potentially have a windfall as their actual loss, due to diminishing property values, may be less than any genuine pre-estimate at the time of entering into the contract. The reverse is the case in a rising market. All of this is known and understood by those operating and funding these contracts."⁵⁶

5.49 Dundas & Wilson gave another pertinent example "where certainty as to the level of penalties is very important":

"... the performance management scheme written into a PFI contract which provides for payment of certain sums and for application of points on the occurrence of specified matters which affect performance or availability of the asset in question. They arise from a "failure to perform". The proposed definition of penalty would cover these provisions. The performance management scheme (PMS) prescribes a

⁵⁶ <https://goo.gl/63UOJA>.

number of standards with which the project company must comply, described as performance and availability standards. If these standards are breached, they trigger a specified sum of money and sometimes points. These sums are then deducted from the regular payments to be received by the project company and then in turn the operating company in question and are known as performance/availability deductions. In addition the project company may accrue points in the event of such breaches which are used as triggers for termination. This PMS is absolutely integral to the operation of PFI/PPP contracts. They are passed down by the project company into the sub contracts with the operator(s). Whilst it might be argued that in such situations the proposed section 1(4) [of the Bill] would not allow circumstances post completion to be taken into account, the fact that there is the slightest risk of this will make funders, authorities and project companies very nervous.”⁵⁷

5.50 If however the courts can only consider the circumstances known to the parties at the time of contracting, the control of ‘excessive penalty’ will be a thing writ in water. On the other hand, if in addition all the circumstances since the contract was made can be taken into account, the certainty which penalty clauses are intended to achieve may be undermined. In our view, however, the risk of uncertainty is considerably reduced if, as we suggest, it is clear law that penalty clauses are valid and enforceable, and that only ‘excessive penalty’ can be the subject of judicial intervention. That such intervention on this ground should be exceptional can be made clear by the way in which the legislation describes or characterises the excess: for example, as ‘manifest’ or ‘gross’. It could also be made explicit that one of the circumstances for the court to consider is what the contracting parties could reasonably assess, or foresee, at the time they made their contract. A mere imbalance between penalty and harm would not be enough to make the former excessive. The court would be bound to look at how matters had appeared to the parties at the time of contracting. This would ensure that Dundas & Wilson’s concern about liquidated damages in long-term arrangements like PFI/PPP schemes could be met, no matter how much property values fluctuated over the 20/25 years of the project. It would be clear that the parties had adopted their clause as a solution to the impossibilities of making any kind of pre-estimation of what the relevant losses might be at the time they actually occurred.

5.51 A useful example of how the suggested approach might work can be gleaned from the ‘Bad Leaver’ case, *Gray v BGHL*.⁵⁸ There, it will be recalled, Lords Brodie and Malcolm held that the time at which to assess the penalty was at the date of contracting, rather than to take into account the actual discrepancy (some £18 million) between the present value of the shares to be returned by the Bad Leaver and what he would receive for them under the clause.⁵⁹ For Lord Menzies, on the other hand, the scale of that discrepancy led to his conclusion that the clause was so penal as to be unenforceable; but he made no reference to the point about timing the assessment of the clause. Lords Brodie and Malcolm were clearly equally aware of the difference in value but also well able to see that at the time of negotiating the term the parties’ decision as to what the penalty should be was, in Lord Malcolm’s words, “a legitimate and proportionate response to the issues and problems likely to arise if and when circumstances justified [the term’s] implementation”.⁶⁰ An express statutory direction that the court determining whether a penalty was excessive should consider as one of the relevant circumstances what the parties could reasonably assess at

⁵⁷ <https://goo.gl/63UOJA>.

⁵⁸ Discussed above, paras 3.46-3.51.

⁵⁹ [2016] CSIH 68 paras 112 (Lord Brodie), 125 (Malcolm).

⁶⁰ [2016] CSIH 68 para 125.

the time of contracting would, we think, produce a similar outcome in future cases of this kind under the suggested reform.

5.52 A final example of which we have been made aware arose from a tripartite joint land development venture, under which each party put in an initial £X million (or its equivalent in value, i.e. the land to be developed), and each also agreed to contribute £X million more apiece within a specified time frame. Default in this second round of contributions would lead to the other parties being able to buy out the defaulter at the market value of its share of the venture. Following the financial crash of 2008, one of the parties was unable to make its second contribution, while the market value of its share in the venture was at that point practically zero. Taking account of the risks inevitably involved in property development, the legitimate interests of the other two parties, and what all parties involved could reasonably assess looking some years ahead of when the joint venture was formed, it seems clear that the penalty against the defaulter here is not excessive.

5.53 Bringing the discussion to this point together in a series of questions, we therefore ask:

13. **Would a useful guideline in determining excessive penalty be a comparison between the stipulated penalty and the actual harm or hurt to the creditor's legitimate interests, considered in the light of what the parties could reasonably assess on these matters at the time of contracting and all other relevant circumstances?**
14. **Should this guideline seek to spell out in a non-exhaustive way what may be a legitimate interest of the creditor in the penalty clause? This could include:**
 - (a) **actual performance of its obligations by the debtor,**
 - (b) **encouragement of prompt or early performance by the debtor,**
 - (c) **avoidance of litigation, and**
 - (d) **other commercial interests of the creditor.**
15. **Views are invited on what more, if any, legitimate interests might be mentioned in such a list, such as:**
 - (a) **the protection of third parties who will suffer loss through breach or other performance-related event but who are not party to the contract and have no other means of recovering their losses;**
 - (b) **the promotion of wider societal goals favoured by the creditor in the obligation.**
16. **Should contracting parties be encouraged to state in their contracts the interests which they seek to protect by their penalty clauses? Are there**

any interests apart from the punishment of the penalty-debtor which should be expressly excluded as illegitimate?

5.54 A second possible factor suggested by the *Cavendish/ParkingEye* decision is whether or not the contract in which the penalty clause appears was negotiated by the parties at arms' length. If it was, then that would point against judicial intervention. We are not certain whether access to independent legal advice is necessarily significant unless, perhaps, it was not available to the party to be made liable under the clause. It should be emphasised, however, that an absence of negotiation between the parties does not necessarily open the door to judicial regulation. The *ParkingEye* case shows that this need not be the case thanks to the factors falling to be considered under the first guideline above.

5.55 In *ParkingEye* the existence and nature of the penalty had also been very clearly brought to the attention of users by prominent signs placed at the entrance to and inside the car park.⁶¹ A further but very different example of an un-negotiated term would be the penalty clauses in the ISDA Master Agreement for derivatives contracts, well-known and widely used throughout the world's financial markets without any negotiation of their terms. But James C Fisher of the University of Tokyo criticises such tests, in particular the conspicuousness of the signage in the *ParkingEye* case, as confusing the issue of incorporation of the clause in the contract with the distinct question of its possible unenforceability if it is part of the contract.⁶² It seems to us, however, to be relevant to the assessment of excessive penalty to consider whether the penalty debtor knew or could reasonably have been expected to know of the penalty at the time of entering the contract. It might be particularly relevant in the 'exit clause' or 'event fee' type of case currently being considered by the Law Commission for England & Wales, our colleagues having found that the substance of these arrangements is very often not brought, or not sufficiently brought, to the attention of the relatively elderly prospective customers for specialist retirement properties.⁶³

5.56 Within our Advisory Group it was suggested that the actual or anticipated resources of the penalty debtor as known to or reasonably anticipated by the creditor at the time of entering the contract might be a relevant factor to be considered. In some cases, the creditor might know that the penalty was one the debtor could not afford to pay and so in effect oppress the debtor into performance of the contract's primary obligations. In the example of the tripartite joint venture given above,⁶⁴ we were told that the initial penalty was not enforced and that instead the parties varied the agreement to give the defaulter an extension for a limited period to make its contribution of £X million, with a sanction for non-payment then of 4 x £X million or an equivalent in kind. In a case of this nature, the knowledge the parties held about the resources available to the defaulter would be relevant in assessing whether or not the renegotiation led to an overshoot of the bounds of permissible penalty.

5.57 Another example figured in the Advisory Group was where consideration of resources might have the effect of supporting the penalty. A two-hour free car park in a leafy suburban supermarket where the overstay penalty was much higher than for the otherwise

⁶¹ For a full description of the signage in *ParkingEye* see [2015] UKSC 67 paras 90-91 (Lords Neuberger and Sumption).

⁶² James C Fisher 'Rearticulating the Rule against Penalty Clauses' [2016] LMCLQ 169-175, at 175.

⁶³ Law Commission Consultation Paper No 226 Residential Leases: Fees on Transfer of Title, Change of Occupancy and Other Events (October 2015) ch 4.

⁶⁴ See para 5.52 above.

equivalent supermarket in a deprived area, based on a belief that a much higher amount was needed to have any impact upon customer behaviour in the former, might be seen as a legitimate protection of the interests of the supermarket.

5.58 We therefore ask:

17. Would further useful guidelines be:

(a) whether the penalty clause had been negotiated between the parties at arms' length;

(b) the availability of independent legal advice to the debtor under the penalty clause at the time of contracting;

(c) where the penalty clause was un-negotiated, the steps taken by the creditor to bring the penalty clause to the debtor's attention at the time of contracting, or the extent to which the debtor was aware of the existence and effect of the clause;

(d) to take account of the actual or anticipated resources of the debtor as known to or reasonably anticipated by the creditor at the time of contracting?

5.59 *ParkingEye* and the ISDA Master Agreement suggest a further possible factor against a court regulating a penalty: the clause reflects custom and practice in the relevant market. The Master Agreement is set up by an internationally recognised body (the International Swaps and Derivatives Association) for world-wide use in the financial markets, while parking charges are part of a set-up allowed by statute in the United Kingdom, informally regulated by the accredited British Parking Association, and in widespread use throughout the United Kingdom. We note too that the control of forfeiture of deposits now accepted for Scots law by Lord Hodge in the *Cavendish/ParkingEye* decision has its starting point in prevailing market norms.⁶⁵

5.60 The factor of market custom and practice would not, of course, prevent findings of penalty in whatever had become established in the market. As Christopher Clarke J remarked in the *BNP Paribas* case, the fact that the ISDA Master Agreement is very widely used in international financial markets "does not mean that its standard provisions may not be penal";⁶⁶ while nothing in the *ParkingEye* decision "means that ParkingEye could charge overstayers whatever it liked."⁶⁷

18. Would another useful guideline be that in determining excessive penalty a court should have regard to custom and practice in the relevant market?

5.61 A further possible factor is the level of the penalty in relation to the materiality to the contract of the breach or other event upon which the clause becomes operational. This

⁶⁵ See para 3.29 above.

⁶⁶ *BNP Paribas v Wockhardt EU Operations (Swiss) AG* [2009] EWHC 3116 (Comm) para 23.

⁶⁷ [2015] UKSC 67 para 100 (Lords Neuberger and Sumption).

would probably be significant in the case where breach was the trigger, but not so otherwise: it would be difficult indeed to ask a court to say that a non-breach event for which the parties had agreed some penalty was nevertheless not material to the contract. Perhaps if accepted at all the test could therefore be confined to breach cases, and rather than being expressed in terms of materiality the test should be framed in terms of trifling or trivial breach. If for example in *ParkingEye* the overstay in the car park had been of just a few seconds or perhaps a couple of minutes, or represented a period when the car was being driven out of the facility but had not reached the exit in time, this factor might make possible the argument that the full penalty of £85 ought not to be exacted. The difficulty would of course lie in gauging to what level the penalty should be reduced in this case (it would not, we think, be eliminated altogether by a court, even if in normal practice the car park operator aware of the circumstances might choose not to exact the charge at all). But in *Cavendish*, for example, there seems to have been no doubt about the materiality of M's breach of covenant, although it was never a matter of proof: the goodwill of the business which he had sold was significantly diminished, if not destroyed, and he had acted in derogation from his own grant.

19. Might there be a guideline that in cases where the penalty becomes operational on a breach of contract a court could have regard to whether or not the breach was trivial?

5.62 With guidelines on factors for consideration in determining penalty in place, it might matter a little less whether the penalty needed to bring the control into play was labelled as 'manifestly' or 'grossly' excessive; or, indeed, as the 'out of all proportion', 'exorbitant', 'extravagant' or 'unconscionable' favoured by the Justices of the Supreme Court in the *Cavendish/ParkingEye* decision. All that would be needed is a word or phrase to make it clear that the excess must be extreme. 'Manifestly' may not do, however, at least if the word carries its dictionary meaning of "evidently (to the eye or understanding), unmistakably".⁶⁸ But we would still maintain that the test should "not [be] a matter of nice calculation".⁶⁹ The test would be, not just whether a clause is penal, but whether it is altogether *too* penal. 'Gross' or 'grossly' may be a better way of suggesting how exceptional it should be for a court to intervene. For the moment, we speak here of 'excessive penalty' while inviting views on what is the most useful phrase with which to characterise that exceptional degree of penalty which brings judicial intervention in its train.

20. Views are invited on the most useful word or phrase (if any) with which to characterise the excessive penalty that is to be subject to judicial control (e.g. 'manifestly' or 'grossly excessive', 'out of all proportion', 'extravagant', 'exorbitant', 'unconscionable'), bearing in mind (1) that the exercise of judicial control is to be exceptional and not a matter of nice calculation in any particular case; and (2) the possible guidelines

⁶⁸ The *Shorter Oxford English Dictionary* notes that 'manifestly' is rarely used as an adverb today. The word 'manifest' appears repeatedly in Land Registration etc (Scotland) Act 2012 s 80 in connection with the Keeper's power to rectify manifest and non-manifest errors in a title sheet or the cadastral map associated with the Land Register. Our Judicial Advisory Group drew attention to the following dictum of Morgan J in the procurement case of *Lion Apparel Systems Ltd v Firebuy Ltd* [2007] EWHC 2179 (Ch) para 38: "[T]he word 'manifest' does not require any exaggerated description of obviousness. A case of 'manifest error' is a case where an error has clearly been made."

⁶⁹ Report 1999, para 3.8.

on what will constitute excessive penalty set out in questions 13-19 above.

Judicial modification

5.63 We now turn away from the guidelines on ‘excessive penalty’ to the question of what orders a court might make when modifying a penalty clause found to be excessively penal in its effects. Our assumption here is that the earlier questions on the possibility of judicial modification have been answered in the affirmative, whether as an alternative to general unenforceability or as the only remedy for excessive penalty.

5.64 A fairly obvious point is that if the law recognises penalties other than the payment of a stipulated sum, then the court must be able to make an order other than mere reduction of the amount payable. It will need power to order the return of an otherwise forfeited pre-paid sum, to undo forfeitures of property other than money, and to end withholdings of performances due to the penalty debtor. It may also need flexibility to respond adequately to the kind of complex situation in which the Court of Appeal found itself in the English case of *Jobson v Johnson*, where the penalty clause bound a purchaser of shares to re-transfer them to the vendor upon non-payment of instalments of the price.⁷⁰ The court offered the penalty-creditor a choice between (1) an order for specific performance provided that this would not over-compensate him; or (2) an order for sale of the shares by the court, with the proceeds going first to pay the vendor the outstanding instalments plus interest thereon, with the remaining balance going to the purchaser. As Lords Neuberger and Sumption acknowledged in the *Cavendish/ParkingEye* case, this achieved “a fair commercial result”.⁷¹

5.65 We acknowledge the difficulty mentioned by Lord Hodge in the *Cavendish/ParkingEye* decision (“how the power of abatement can extend to modifying the price of a compulsorily transferred asset”).⁷² But our 1999 Report noted the case “where a forfeiture of property would be a manifestly excessive penalty by itself but would cease to be so if the person forfeiting the property were compensated for improvements made to it.”⁷³ Another example of how such difficult questions could be approached may be the ‘Bad Leaver’ type of case, where a departing employee must give up a valuable shareholding in the company he or she may have helped to build up. If the court finds the penalty excessive, there should perhaps be some countervailing consideration of the employee’s contribution to the value the shareholding now has in the market.

5.66 We would tentatively suggest, therefore, that the best approach might be to enable the court to grant any order that seems just in all the circumstances when it modifies an excessive penalty clause (or holds it unenforceable, if the latter sanction continues to be available). More precise legislative guidance than this might cause more difficulty than give help to courts and practitioners. But it might be helpful if the list of factors to be taken into account in determining excessive penalty could also be used by the courts in exercising their power of modification. The South African Conventional Penalties Act 1962 says that in determining the proportionality of the penalty to the prejudice of the creditor “the court shall

⁷⁰ *Jobson v Johnson* [1989] 1 WLR 1026 (CA).

⁷¹ [2015] UKSC 67 para 85.

⁷² [2015] UKSC 67 para 283 (see para 3.33 above).

⁷³ Report 1999, para 6.16.

take into consideration not only the creditor's proprietary interest, but every other rightful interest which may be affected by the act or omission";⁷⁴ that is, in our terms, the legitimate interests which the penalty-creditor is entitled to protect.

5.67 We seek views on that approach, and also on the model of the DCFR, which is premised on the view that the court's power to *modify* should not extend as far as complete *elimination* of any penal element. The modification should respect the parties' decision to include a penalty in their contract. We think it consistent with the basic enforceability of penalties so to provide. Only the excess in the penalty should be removed. But this approach would, we think, be a significant change to the Scots law on judicial modification which seems to focus primarily on reducing the penalty to the creditor's proven losses.⁷⁵ The approach would certainly entail the repeal of the words in section 5 of the Debts Securities (Scotland) Act 1856 quoted above at paragraph 2.17 and in the footnote below.⁷⁶ These words, it should be noted, seem never to have been judicially referred to in any reported case prior to the *Wirral Borough Council and Cavendish/ParkingEye* cases.

5.68 We ask accordingly:

- 21. Should the court be empowered to grant any order that seems just in all the circumstances when it modifies an excessively penal clause (or holds it unenforceable if that sanction is retained)?**
- 22. Should the court be encouraged to use the list of factors to be taken into account in determining excessive penalty in making any order modifying the penalty in question?**
- 23. Should it be more specifically provided that any order for modification of an excessive penalty should do no more than remove its excessive element?**
- 24. If the answer to the preceding question is affirmative, do consultees agree that the words from "in all cases" to "making the debt effectual" in section 5 of the Debts Securities (Scotland) Act 1856 should be repealed?**

5.69 There could also be utility in a specific legislative statement that a clause which liquidates damages, i.e. one which at the time of contracting was based on a genuine pre-estimate of the loss likely to be suffered as the result of a breach of contract, cannot be treated as penal whatever the subsequent circumstances might suggest. This would allay concerns expressed since the *Cavendish/ParkingEye* decision that liquidated damages clauses are now more vulnerable to challenge than they were before the judgments. While we think that this is not a justified fear, given what the Justices themselves said on the

⁷⁴ Conventional Penalties Act 1962 s 3 (SA).

⁷⁵ See paras 5.27-5.28 above.

⁷⁶ For ease of reference, the words are also given here in full: "in all cases where penalties for non-payment, over and above performance, are contained in bonds or other obligations for sums of money, and are made the subject of adjudication, or of demand in any other shape, it shall be in the power of the court to modify and restrict such penalties, so as not to exceed the real and necessary expenses incurred in making the debt effectual."

subject, it might nonetheless be useful to reaffirm the position specifically in altogether new legislation rather than leave the question unanswered until judicial applications emerge. This would also make it clear that such clauses were not subject to the judicial modification power.

5.70 Such a statement might be thought un-necessary if the legislation began with an abolition of the rule against penalties. This would be reinforced, it is thought, if the suggested guidelines on ‘excessive penalty’ stated that the comparison between the stipulated penalty and the actual harm or hurt included consideration of what could have been reasonably assessed by the parties at the time of contracting. But there might be important greater certainty if there was a specific legislative statement on liquidated damages clauses, especially in relation to long-term contracts like the PFI/PPP schemes drawn to our attention by Dundas & Wilson in the Scottish Government’s 2010 consultation.⁷⁷

25. Should the legislation provide specifically that clauses which provide for liquidated damages, i.e. are based on a genuine pre-estimate of the loss likely to be caused by a breach of contract, cannot be held to be penal, no matter what the later circumstances may be?

5.71 A further general point arises if judicial modification is the only remedy for excessive penalty. That is whether the remedy should be at the discretion of the court, as provided in our draft Bill in 1999, or whether the court should be required to apply it when it finds a penalty excessive. It seems to us that, were modification the only remedy, it should not be at the court’s discretion to apply it. As the Law Society of Scotland remarked in the 2010 consultation:

“[A]lthough the draft Bill does give a court a power to modify a penalty clause under s. 4, it does not require the court to do so. The court will only do so on application and, even then, only “if it thinks fit”. This is unhelpful.”⁷⁸

5.72 We note that in the proposed reform of the Swiss Code of Obligations the judicial modification remedy would cease to be discretionary. But we do not think that the Law Society meant by its comment that the judge should be empowered to apply the remedy of his or her own motion, as for example in France, rather than having to wait for an application by an affected party.⁷⁹ It is true that the basis of the rule against penalties in public policy might be thought to make it the judge’s duty to ensure that the court was not used in ways going against that public policy, whether or not a party raised the question.⁸⁰ But we think that it is more consistent with a general approach favouring enforceability except in extreme cases to say that only a party can raise the question of penalty and that the court must exercise its modifying power if satisfied that the penalty is excessive.

⁷⁷ Note however that under our tentative proposals on transitional provisions the new law would not apply to penalty clauses agreed before any new legislation came into force.

⁷⁸ <https://goo.gl/8rsKml>, para 1.2(5).

⁷⁹ See para 2.39 above. In *United Dominions Trust Ltd v McDowell* 1984 SLT (Sh Ct) 10 the sheriff dismissed an undefended payment action *ex proprio motu* on the basis that the conventional sum sued for following a breach of contract was exorbitant and a clear penalty; but this was over-ruled by the sheriff principal on the grounds that the sheriff had no power so to act. In South Africa “the court may reduce the penalty of its own accord if it is apparent from the pleadings that the penalty is excessive (for example, in application for default judgment against the debtor)” (Hutchison (ed), *Law of Contract in South Africa* 344). Note also A J Kerr, ‘The Role of the Court in Civil Cases: The Conventional Penalties Act’ (1991) 108 South African LJ 245.

⁸⁰ See Gloag *Contract* p 549; *SME* vol 15 para 766.

26. Do consultees agree that only a party should be able to raise the issue of excessive penalty?
27. Should the court be required to modify a penalty found to be excessive, or should the remedy be at the discretion of the court?

Onus of proof of penalty

5.73 In our previous Report we recommended that the initial onus of proof should lie on the party who makes the allegation of penalty. We continue to think that this should be the case. It seems to us that the onus of showing that there is excessive penalty should lie on the party who makes this allegation, especially if it is made clear, as we suggest above, that penalties are generally valid and enforceable. Further, as the question of onus appears to be a matter of doubt under the existing law,⁸¹ it would anyway be helpful to have clarification of the position.

5.74 Having regard to the guidelines on excessive penalty discussed above, it would be for the person against whom the penalty was being enforced to prove such matters as the imbalance between the stipulated penalty and the hurt or harm to the creditor's legitimate interests, that the contract was not negotiated at arms' length, or with the debtor receiving independent legal advice, or the debtor's lack of knowledge of the existence and effect of the clause, or the clause not being in line with existing market custom or practice.

5.75 The main difficulty to which this position gives rise is that it might be impossible for the debtor to provide details of the creditor's loss or other 'harm or hurt' to its interests. The countervailing factor is that the imbalance between penalty and actual harm is not meant to be a matter of 'nice calculation'. Lord Halsbury long ago gave the example of the penalty of a million pounds for failure to build within a year a house for £50;⁸² we would not expect the courts to need detailed averments or proof from the debtor in that clause to shift the onus to the other side to explain and justify the penalty.

5.76 If, on the other hand, the initial onus of showing that a penalty was not excessive was placed on the party enforcing it, the result would probably be a considerable change in practice. For example, in building contracts and charterparties, where penalty clauses are at present rarely challenged,⁸³ there would be some incentive whenever a penalty was claimed for the contractor or charterer to claim that the amount was excessive, forcing the employer or ship-owner to justify the sum sought. This would defeat one of the virtues of penalty clauses, that they minimise dispute.

5.77 We ask accordingly:

28. Do consultees agree that the initial onus of showing that a penalty is excessive should lie on the party so contending?

⁸¹ In *Wirral Borough Council v Currys Group plc* 1998 SLT 463 Lord Hamilton reserved his opinion on questions of onus of proof.

⁸² *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* (1904) 7 F (HL) 77, 78.

⁸³ DP 1997, para 3.2(2).

Cumulation of penalty and other remedies

5.78 When a penalty is due for delayed performance (e.g. in a construction contract), the creditor may be entitled both to enforce performance of the contract by way of specific implement and to claim the penalty due for lateness of performance. But if the penalty is enforceable the creditor cannot ignore it and instead claim damages for any breach of contract that triggered the clause. Nor does the debtor have the option of paying the penalty instead of performing the contract.⁸⁴ As has been said:

“When a penalty is imposed to enforce an obligation, no option is given to the party against whom it is directed to get quit of his obligation by paying the penalty. In the language of the law of Scotland the penalty is by and attour performance. It is one mode of enforcing the obligation added to every other mode which would otherwise have been competent.”⁸⁵

5.79 We do not think, however, that there is any absolute bar on the cumulation of a penalty with other remedies so long as they are ‘not inconsistent’ with each other.⁸⁶ In Chapter 2 we noted how it is provided in some of the Civil law jurisdictions that losses over and above the amount of any penalty may be additionally claimed by way of ordinary damages.⁸⁷ That seems to us to be theoretically possible in present Scots law also, even if it is rather unlikely to arise in practice very often.⁸⁸ We do not think it would be ruled out if the tentative reform suggestions made in this Chapter were to be implemented in statute.

5.80 Section 2 of the South African Conventional Penalties Act 1962 provides however for a prohibition on cumulation of a penalty and other remedies “in respect of defects and delay”:

“(1) A creditor shall not be entitled to recover in respect of an act or omission which is the subject of a penalty stipulation, both the penalty and damages, or, except where the relevant contract expressly so provides, to recover damages in lieu of the penalty.

(2) A person who accepts or is obliged to accept defective or non-timeous performance shall not be entitled to recover a penalty in respect of the defect or delay, unless the penalty was expressly stipulated for in respect of that defect or delay.”

5.81 In our previous Report we did not think it necessary to make similar legislative provision in Scotland. There is a case for legislative economy in the reform of the law and we continue to think that any problems of cumulation of remedies can be left to be decided by the courts in the light of what the parties have expressly agreed and the general principle that there cannot be any cumulation of inconsistent remedies. Under our proposed reform

⁸⁴ For this paragraph see McBryde *Contract* para 22.173.

⁸⁵ Per consulted judges in *University of Glasgow v Faculty of Physicians and Surgeons* (1840) 1 Rob 397 at 415 cited in Gloag *Contract* p 673. It was held competent to enforce a penalty and have interdict. ‘By and attour’ means ‘over and above’.

⁸⁶ McBryde *Contract* para 22.173.

⁸⁷ See para 2.34 (Germany) above.

⁸⁸ But see *Dingwall v Burnett* 1912 SC 1097 where under the scheme we tentatively suggest above the penalty would probably be enforceable but the penalty-creditor’s actual loss was much greater in amount. In the case the holding that the clause was a penalty meant its unenforceability but the penalty-creditor recovered his losses by way of common law damages instead, the penalty providing no cap thereon.

scheme it is very unlikely indeed that a penalty will be found to be excessively penal when the creditor in the penalty has suffered an even greater loss that would be recoverable in the ordinary law.

5.82 We ask accordingly:

- 29. Do consultees agree that it is not necessary to have legislative provision on the cumulation of a penalty and other remedies?**

Contracting out

5.83 Our previous Report recommended that any new law on penalty clauses should make it clear that parties cannot contract out of the application of the law, describing having such a provision as 'prudent'. We continue to think this, having in mind in particular the public policy dimension that is the basis for regulation of excessively penalty. It is also important for the purposes of international private law, in making the rules non-derogable for the purposes of article 3(3) of the Rome I Regulation, i.e. if a contract was subject to, say, English law but all other elements pointed to Scots law as the applicable law, the Scottish penalties rules would have to be applied by the court with jurisdiction in the case. We therefore ask:

- 30. Do consultees agree that in any law on penalty clauses it should be made clear that parties cannot contract out of the application of that law?**

Application to bonds and unilateral obligations

5.84 In our previous Report we recommended that the proposed rules on penalty clauses should apply to penalty clauses in bonds and other unilateral voluntary obligations in the same way as to penalty clauses in contracts. This was considered to be appropriate as the same principles and policy considerations apply to unilateral voluntary obligations and contracts. We continue to see the matter in this way. We therefore ask:

- 31. Do consultees agree that the proposed rules on penalties should apply to penalties provided for in bonds and other unilateral voluntary obligations in the same way as to those provided for in contracts?**

Transitional provisions

5.85 In our previous Report we recommended that any new legislation should apply only to penalty clauses agreed after it comes into force. The argument for retrospective effect is that control of clauses with excessively penal effects is called for by justice and public policy considerations. The argument against is that a person might have been advised under the previous law that a proposed clause could not be regarded as liquidated damages and so, being unenforceable, could be safely accepted; it would be unfair to that person if it was suddenly transformed into a valid and enforceable penalty. This still seems to us the stronger argument, despite the picture being somewhat clouded by the change in the law already effected by the *Cavendish/ParkingEye* decision, with which, we think, our proposals show much continuity. Should the law reform proposal be for outright abolition of the present penalties rule, in whole or in part, we think that the same conclusion follows.

5.86 We ask:

- 32. Do consultees agree that any new legislation (including the outright abolition of the penalties rule, in whole or in part) should apply only to penalty clauses agreed after it comes into force?**

Conclusion

5.87 A summation of the tentative proposals made in this long chapter may be a useful way to conclude it. We think that in its broad outline the scheme offers greater certainty than exists under the present law. Above all, perhaps, the law's starting point would be the validity and enforceability of penalty clauses. Freedom and sanctity of contract would be duly supported. Negotiation and drafting of penal terms would thereby become less difficult than at present. Parties and their advisers could also increase their certainty by ensuring that any penalty provided for in the contract was based upon an interest of the penalty-creditor which the law expressly recognised as legitimate while not excluding the possible recognition of other interests. The judicial control over penalty would only apply to particular kinds of clause defined in concrete terms (e.g. operative upon breach; arising on early termination; arising from the availability of different modes of performance). The rather abstract and difficult notions of obligations primary, secondary or conditional primary would no longer require analysis.

5.88 The judicial control would however be exercisable only in rare cases of 'excessive', 'manifest', or 'gross' penalty'. Penalty would also be assessed, not from the penalty clause in the abstract, but with judicial knowledge of its actual penal effects and their relation to the creditor's recognised legitimate interests. Judicial modification so defined would be narrower in scope than the present Scots law (which, it should be noted, has nevertheless been very little used and is not even well-known to practitioners). The control would also be less strong than in the present law (which seems to require the judge to cut the penalty back to the creditor's actual losses); the approach would instead be to remove only the excessiveness of the penalty where that excess was manifest or gross.

5.89 That such a control of excessive penalty existed would, however, provide a party negotiating a contract in which it was to be subject to a penalty with a basis for seeking some limits on its exposure to the creditor. The drafter might also in at least some cases sensibly include within the penalty some recognition of the penalty-debtor's interests: for example, in a forfeiture or transfer of property case, by making express allowance for the debtor's contribution to the current value of the property being forfeited or transferred to the creditor. Such contractual provision might well be sufficient to fend off any risk of a later judicial intervention to similar effect.

5.90 For these reasons, we think that the scheme tentatively proposed in this Chapter reduces a number of uncertainties in the present law, and does not add in any new ones, save that perhaps the judicial modification power will become better known to legal practitioners. We would however anticipate that its use in court will remain infrequent, while its existence may provide some balance in the negotiation of penalty clauses.

Chapter 6 Law Reform Questions and Proposals

1. Do consultees know of information or statistical data or have comments on any actual or potential economic impacts of either the current law relating to penalty clauses or any proposed reform of that law? We would especially value information about why and how penalty clauses are used, the effects of their deployment, and their impact on small and medium-sized enterprises.

(Paragraph 1.16)

2. Should the decision in *Cavendish Square Holding BV v Talal El Makdessi* and *ParkingEye Limited v Beavis* be left to 'bed in', with the further development of the law and its application being kept under review, but no specific law reform being recommended at this point?

(Paragraph 4.16)

3. Should the common law on penalties be abolished (i) outright; or (ii) in its application to contracts between parties all acting in the course of business; or (iii) in its application to consumer contracts?

(Paragraph 4.24)

4. Should it be provided that the common law rule against penalties is abolished, to be replaced by a regime directed at regulating specified types of contract terms if they have excessively penal effects?

(Paragraph 4.36)

5. Should a term of a contract be regarded as potentially subject to regulation for penalty only if it becomes operational upon a breach of contract by the party to whom the penalty would be applied?

(Paragraph 5.11)

6. Or should the scope of the concept be extended to cover also terms:

(a) providing for early termination of the contract and/or

(b) giving a party options between different ways of performing its obligations under the contract but the choice of one has relatively adverse consequences for the party compared to the other?

(Paragraph 5.11)

7. In the light of the proposed express provision making contractual penalties generally enforceable, do consultees agree that judicial control over contractual penalties that are excessively penal in their effects should be possible whatever form the penalty takes (e.g. a payment, a forfeiture, a transfer of property, a withholding of performance otherwise due)? Please explain any disagreement, including that relating to any particular kind of clause.

(Paragraph 5.20)

8. Is it un-necessary to empower the court to consider substance rather than form when deciding whether a clause is within the scope of the new rule against 'excessive penalty'?

(Paragraph 5.20)

9. Do consultees also agree that there should be provision exempting from judicial control penalties which are specifically provided for in other enactments or rules of law?

(Paragraph 5.20)

10. Do consultees agree that conventional irritancy clauses should be excluded from the controls against 'excessive penalty'?

(Paragraph 5.24)

11. Should it cease to be possible for a court to declare a clause unenforceable for excessive penalty (apart from consumer cases)?

(Paragraph 5.32)

12. Should the only sanction for the excessive penalty of a clause (apart from consumer cases) be judicial modification?

(Paragraph 5.32)

13. Would a useful guideline in determining excessive penalty be a comparison between the stipulated penalty and the actual harm or hurt to the creditor's legitimate interests, considered in the light of what the parties could reasonably assess on these matters at the time of contracting and all other relevant circumstances?

(Paragraph 5.53)

14. Should this guideline seek to spell out in a non-exhaustive way what may be a legitimate interest of the creditor in the penalty clause? This could include:

- (a) actual performance of its obligations by the debtor,
- (b) encouragement of prompt or early performance by the debtor,
- (c) avoidance of litigation, and

(d) other commercial interests of the creditor.

(Paragraph 5.53)

15. Views are invited on what more, if any, legitimate interests might be mentioned in such a list, such as:

- (a) the protection of third parties who will suffer loss through breach or other performance-related event but who are not party to the contract and have no other means of recovering their losses;
- (b) the promotion of wider societal goals favoured by the creditor in the obligation.

(Paragraph 5.53)

16. Should contracting parties be encouraged to state in their contracts the interests which they seek to protect by their penalty clauses? Are there any interests apart from the punishment of the penalty-debtor which should be expressly excluded as illegitimate?

(Paragraph 5.53)

17. Would further useful guidelines be:

- (a) whether the penalty clause had been negotiated between the parties at arms' length;
- (b) the availability of independent legal advice to the debtor under the penalty clause at the time of contracting;
- (c) where the penalty clause was un-negotiated, the steps taken by the creditor to bring the penalty clause to the debtor's attention at the time of contracting, or the extent to which the debtor was aware of the existence and effect of the clause;
- (d) to take account of the actual or anticipated resources of the debtor as known to or reasonably anticipated by the creditor at the time of contracting?

(Paragraph 5.58)

18. Would another useful guideline be that in determining excessive penalty a court should have regard to custom and practice in the relevant market?

(Paragraph 5.60)

19. Might there be a guideline that in cases where the penalty clause becomes operational on a breach of contract a court could have regard to whether or not the breach was trivial?

(Paragraph 5.61)

20. Views are invited on the most useful word or phrase (if any) with which to characterise the excessive penalty that is to be subject to judicial control (e.g. 'manifestly' or 'grossly excessive', 'out of all proportion', 'extravagant', 'exorbitant', 'unconscionable'), bearing in mind (1) that the exercise of judicial control is to be exceptional and not a matter of nice calculation in any particular case; and (2) the possible guidelines on what will constitute excessive penalty set out in questions 13-19 above.

(Paragraph 5.62)

21. Should the court be empowered to grant any order that seems just in all the circumstances when it modifies an excessively penal clause (or holds it unenforceable if that sanction is retained)?

(Paragraph 5.68)

22. Should the court be encouraged to use the list of factors to be taken into account in determining excessive penalty in making any order modifying the penalty in question?

(Paragraph 5.68)

23. Should it be more specifically provided that any order for modification of the excessive penalty should do no more than remove its excessive element?

(Paragraph 5.68)

24. If the answer to the preceding question is affirmative, do consultees agree that the words from "in all cases" to "making the debt effectual" in section 5 of the Debts Securities (Scotland) Act 1856 should be repealed?

(Paragraph 5.68)

25. Should the legislation provide specifically that clauses which provide for liquidated damages, i.e. are based on a genuine pre-estimate of the loss likely to be caused by a breach of contract, cannot be held to be penal, no matter what the later circumstances may be?

(Paragraph 5.70)

26. Do consultees agree that only a party should be able to raise the issue of excessive penalty?

(Paragraph 5.72)

27. Should the court be required to modify a penalty found to be excessive, or should the remedy be at the discretion of the court?

(Paragraph 5.72)
28. Do consultees agree that the initial onus of showing that a penalty is excessive should lie on the party so contending?

(Paragraph 5.77)
29. Do consultees agree that it is not necessary to have legislative provision on the cumulation of a penalty and other remedies?

(Paragraph 5.82)
30. Do consultees agree that in any law on penalty clauses it should be made clear that parties cannot contract out of the application of that law?

(Paragraph 5.83)
31. Do consultees agree that the proposed rules on penalties should apply to such penalties provided for in bonds and other unilateral voluntary obligations in the same way as to those provided for in contracts?

(Paragraph 5.84)
32. Do consultees agree that any new legislation (including outright abolition of the penalties rule, in whole or in part) should apply only to penalty clauses agreed after it comes into force?

(Paragraph 5.86)

Appendix A

International instruments

DCFR	PIC	PECL
<p>III.–3:712: Stipulated payment for non-performance</p> <p>(1) Where the terms regulating an obligation provide that a debtor who fails to perform the obligation is to pay a specified sum to the creditor for such non-performance, the creditor is entitled to that sum irrespective of the actual loss.</p> <p>(2) However, despite any provision to the contrary, the sum so specified in a contract or other juridical act may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances.</p>	<p>Art. 7.4.13 Agreed payment for non-performance</p> <p>(1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm.</p> <p>(2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.</p>	<p>Art. 9.509: Agreed payment for non-performance</p> <p>(1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of its actual loss.</p> <p>(2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances.</p>

Other jurisdictions

Germany	France	Netherlands
<p>BGB</p> <p>§ 339: Payability of contractual penalty</p> <p>If the debtor promises the creditor the payment of a sum of money in case he does not perform his obligation or does not perform it in the proper manner, the penalty is forfeited if he is in default through delay. If performance due consists in a forbearance, the penalty is forfeited as soon as any act in contravention of the obligation is committed.</p> <p>§ 340: Promise to pay a penalty for non-performance</p> <p>(1) If the debtor has promised the penalty for the case of his not fulfilling his obligation, the creditor may demand the forfeited penalty in lieu of performance. If the creditor declares to the debtor that he demands the penalty, the claim for performance is barred.</p> <p>(2) If the creditor has a claim for compensation for non-performance, he may demand the forfeited penalty as the minimum amount of the damage. Proof of further damage is not inadmissible.</p> <p>§ 341: Promise of a penalty for improper performance</p> <p>(1) If the debtor has promised the penalty for the case of his not performing the obligation in the proper manner, in particular not at</p>	<p>New French Law of Obligations (in force 1 October 2016)</p> <p>Where a contract stipulates that the person who fails to perform shall pay a certain sum of money by way of damages, the other party may be awarded neither a higher nor a lower sum.</p> <p>Nevertheless, a court may, even of its own initiative, moderate or increase the penalty so agreed if it is manifestly excessive or derisory.</p> <p>Where an undertaking has been performed in part, the agreed penalty may be reduced by a court, even of its own initiative, in proportion to the advantage which partial performance has procured for the creditor, without prejudice to the application of the preceding paragraph.</p> <p>Any stipulation contrary to the preceding two paragraphs is deemed not written.</p> <p>Except where non-performance is permanent, a penalty is not incurred unless the debtor was put on notice to perform.</p> <p>Code Civil (pre-2016)</p>	<p>BW</p> <p>Article 6:91: Any clause which provides that an obligor, should he fail in the performance of his obligations, must pay a sum of money or perform another obligation is considered to be a penalty clause, irrespective of whether this is to repair damage or only to encourage performance.</p> <p>Article 6:92: 1. The obligee may not demand performance of both the penalty clause and the obligation to which the penalty relates. 2. Whatever is due pursuant to a penalty clause takes the place of damages due by law. 3. The obligee may not demand performance of the penalty clause where the failure in the performance of the obligation cannot be attributed to the obligor.</p> <p>Article 6:93: A warning or other prior declaration is required in order to demand performance of the penalty clause in the same cases as such is required to claim damages due by law.</p> <p>Article 6:94: 1. The court may reduce the stipulated penalty upon the demand of the obligor if it is evident that fairness so requires; the court, however, may not award the obligee</p>

<p>the stipulated time, the creditor may demand the forfeited penalty in addition to the performance.</p> <p>(2) If the creditor has a claim for compensation on account improper performance, the provisions of § 340(2) apply.</p> <p>(3) If the creditor accepts the fulfilment, he may demand the penalty, only if on acceptance he reserves the right to do so.</p> <p>§ 342: Alternatives to monetary penalty</p> <p>If a performance other than the payment of a sum of money is promised as penalty, the provisions of §§ 339 to 341 apply; the claim for compensation is barred if the creditor demands the penalty.</p> <p>§ 343: Reduction of the penalty</p> <p>(1) If a forfeited penalty is disproportionately high, it may be reduced to a reasonable amount by judicial decree on the application of the debtor. In the determination of reasonableness every legitimate interest of the creditor, not merely his property interests shall be taken into consideration. The claim for reduction is barred if the penalty has already been paid.</p> <p>(2) The same rule applies also, apart from the cases provided by §§ 339, 342, if a person promises a penalty for the case of his doing or forbearing some act.</p> <p>§ 344: Ineffective promise of a penalty</p>	<p>reform)</p> <p>Article 1152: Where an agreement provides that he who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater or a lesser sum. Nevertheless the judge may “even of his own motion” (Act no 85-1097 of 11 October 1985) moderate or increase the agreed penalty, where it is obviously excessive or ridiculously low. Any stipulation to the contrary shall be deemed unwritten.</p> <p>Article 1228: A creditor, instead of claiming the penalty stipulated against the debtor who is under notice of default, may proceed with the performance of the principal obligation.</p> <p>Article 1229: A penalty clause is a compensation for damages which the creditor suffers from the non-performance of the principal obligation. He may not claim at the same time the principal and the penalty, unless it was stipulated for a mere delay.</p> <p>Article 1230: Whether the original obligation contains no term within which it must be performed, the penalty is incurred only where the one who is bound either to deliver, or to take, or to do, is under notice of default.</p> <p>Article 1231:</p>	<p>less than the damages due by law for failure in the performance.</p> <p>2. The court may award supplementary damages upon the demand of the obligee if it is evident that fairness so requires; these in addition to the stipulated penalty intended to take place of damages due by law.</p> <p>3. Stipulations derogating from paragraph 1 are null and void.</p>
--	---	--

<p>If the law declares the promised performance invalid, an agreement made for a penalty for non-fulfilment of the promise is also invalid even if the parties knew of the invalidity of the promise.</p> <p>§ 345: Burden of proof</p> <p>If the debtor contests the forfeiture of the penalty on the ground of having performed his obligation, he is required to prove the performance unless the performance due from him consisted in a forbearance.</p> <p>HGB § 348: A contract penalty, promised by a merchant operating a commercial concern, cannot be reduced on the basis of the provisions of § 343 BGB.</p>	<p>Where an undertaking has been performed in part, the agreed penalty may, “even of his own motion,” (Act no 85-1097 of 11 October 1985) be lessened by the judge in proportion to the interest which has accrued for the creditor, without prejudice to the application of Article 1152. Any stipulation to the contrary shall be deemed not written.</p>	
---	---	--

Appendix B

Judicial Advisory Group

Lord Tyre

Lady Wolffe

Lord Doherty

Advisory Group

Dr Ross Gilbert Anderson (Ampersand, Faculty of Advocates)

Professor Mark Godfrey (Glasgow University)

Greg Gordon (Aberdeen University)

Professor Martin Hogg (Edinburgh University)

Bobby Lindsay (Glasgow University)

Alistair McLean (Brodies)

Fenella Mason (Burness Paull)

Brenda Scott (Brodies)

Claire Scott (Burness Paull)

Lindsay Wallace (Burness Paull)

Caroline Wilson (CMS Cameron McKenna)



Published on behalf of the Scottish Law Commission by APS Group Scotland

This Document is available for download from:
www.scotlawcom.gov.uk

ISBN: 978-0-9935529-4-6

PPDAS83335 (11/16)