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# Unresolved Issues in the Law on Penalties

Andrew Summers<sup>1</sup>

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The article examines several unresolved issues in the law on penalties, following the UK Supreme Court's restatement of the penalties rule in *Makdessi v Cavendish Square Holding* [2015] UKSC 67. The discussion is divided into three main sections, concerning: the jurisdiction (or scope) of the rule; the test for the validity of impugned clauses; and the effect of the rule. The central argument is that although the court's decision to limit the rule's application at both the jurisdiction and validity stages will increase parties' certainty that their clauses will be enforced, the restatement leaves the law itself uncertain in several key respects.

## I. INTRODUCTION

The dust has now had time to settle following the Supreme Court's restatement of the rule against penalties in *Makdessi v Cavendish Square Holdings*.<sup>2</sup> Yet several issues remain unresolved. The focus of analysis to date has been on what the court *did* decide;<sup>3</sup> by contrast, this article addresses the various issues that are likely to require further decision. In holding that the penalties rule survives, albeit in a narrowed form, it has been suggested that the Supreme Court "espoused tests that are clear and workable".<sup>4</sup> This article takes a different view. Although it was perhaps inevitable that the Supreme Court's restatement would not be entirely comprehensive, *Makdessi* creates new uncertainties. The decision to narrow the rule at both the jurisdiction and validity stages will increase parties' certainty that their clauses will be enforced, but the restatement leaves the law itself less clear than before.

The structure of the article reflects the three separate stages involved in applying the penalties rule: jurisdiction, validity and effect.<sup>5</sup> Taking each stage in turn, the article offers a very brief overview of the issues that were settled in *Makdessi* (for better or worse), followed by a more detailed analysis of the issues that were left unresolved. The

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<sup>2</sup> *Makdessi v Cavendish Square Holdings BV* [2015] UKSC 67, [2015] 3 WLR 1373 (hereafter "*Makdessi*").

<sup>3</sup> See, recently, J Fisher, "Rearticulating the Rule Against Penalty Clauses" [2016] LMCLQ 169; F Dawson, 'Determining Penalties as a Matter of Construction' [2016] LMCLQ 207; J Morgan, "The Penalty Clause Doctrine: Unlovable but Untouchable" [2016] CLJ 11; C Conte, "The Penalty Rule Revisited" (2016) 132 LQR 382.

<sup>4</sup> Conte (n3) 385.

<sup>5</sup> This terminology is gratefully adopted from Carmine Conte. The first two stages have not always been distinguished clearly in the authorities, but they were correctly separated in the judgment of Lord Neuberger and Lord Sumption in *Makdessi* [12]-[18] (jurisdiction) and [19]-[35] (validity).

common theme running through this analysis is that while the new tests for jurisdiction and validity were superficially clear, on closer inspection all that can really be said with certainty is that they are narrower than before. The key concepts upon which the new tests rely are seriously flawed, even on their own terms, and in this respect they open the door to further litigation in a suitable case.

On the jurisdiction stage, we now know that the penalties rule survives, that its application depends on breach (and so can be circumvented by careful drafting), and that it extends beyond payments of money. But several key issues may require further decision. These include the application of the “substance over form” test for determining whether a clause is triggered by breach; the unworkable distinction between “conditional primary obligations” and “secondary obligations”; and the application of the jurisdiction test to clauses that provide for the retention of property or money upon breach. Although it is clear that the new jurisdiction test is narrower than the old breach requirement, its application on the facts of *Makdessi* itself foreshadows the difficulties that are likely to be faced.

On the validity stage, we now know that a clause may be upheld even though it was not a genuine pre-estimate of loss, and even though it aimed to deter breach; instead, validity now centres on the interrelated concepts of legitimate interest, exorbitance and unconscionability. However, new uncertainties have been created by importing the concept of a “legitimate interest” into the law of penalties. In particular: legitimate interest in what? -and whose legitimate interest? Though the answers to these questions appeared clear enough in the abstract, they fell apart in application to the *ParkingEye* appeal.<sup>6</sup> Further unresolved issues include the scope of the new dichotomy between legitimate interest and punishment and the appropriate weight for procedural considerations.

On the effect of the rule, the decision in *Makdessi* plays an important clarificatory role in settling that a penalty clause is wholly unenforceable. Contrary to some previous authorities, the court is not empowered to rewrite the parties’ bargain by “scaling down” the clause. However, an important consequence of this development, so far under-appreciated in analyses of the decision, is that the “all-or-nothing” approach to enforceability further raises the stakes at the jurisdiction and validity stages. In practice, the rule’s newly sharpened teeth make it less likely that it will successfully be invoked. Only the very limited (and distinct) scope of the rule for relief against forfeiture provides any chance of a “compromise” position.

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<sup>6</sup> This appeal was joined with *Makdessi* in the Supreme Court.

## II. JURISDICTION

### A. What we know

We know that the rule against penalties survives. Despite acknowledging some misgivings,<sup>7</sup> the panel of seven Justices in *Makdessi* unanimously declined to abrogate the rule altogether.<sup>8</sup> Nor would the court countenance any formal exception for commercial transactions.<sup>9</sup> Although the survival of the penalties rule evidently owes something to judicial conservatism,<sup>10</sup> the court also cited the need to protect parties from the risks of inequality of bargaining power in circumstances not covered by legislation.<sup>11</sup> Such justifications were already well-known prior to *Makdessi*, as were the countervailing considerations of certainty and freedom of contract. This normative equation is unaltered by the Supreme Court's decision and will no-doubt continue to be debated.<sup>12</sup>

We now also know that the penalties rule only applies to clauses triggered by breach.<sup>13</sup> In other words, the rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves.<sup>14</sup> Although this was commonly assumed to be the position in English law before *Makdessi*,<sup>15</sup> express authority had been surprisingly thin.<sup>16</sup> The breach requirement had recently been

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<sup>7</sup> *Makdessi* [3] and [36] (Lord Neuberger and Lord Sumption) and [258]-[259] (Lord Hodge).

<sup>8</sup> *Makdessi* [36]-[39] (Lord Neuberger and Lord Sumption), [162]-[167] (Lord Mance) and [261]-[266] (Lord Hodge). This conclusion was fortified by the existence of equivalent rules in other common law and civil jurisdictions: *Makdessi* [37] (Lord Neuberger and Lord Sumption), [164]-[166] (Lord Mance) and [263]-[265] (Lord Hodge).

<sup>9</sup> *Makdessi* [168] (Lord Mance) and [267] (Lord Hodge). However, where the transaction is between commercial parties of equal bargaining power, there is a "strong presumption" of validity: see further text to n209.

<sup>10</sup> *Makdessi* [162] (Lord Mance): "there would have to be shown the strongest reasons for so radical a reversal of jurisprudence which goes back over a century". See also [36] (Lord Neuberger and Lord Sumption).

<sup>11</sup> *Makdessi* [38] (Lord Neuberger and Lord Sumption), [167] (Lord Mance) and [262] (Lord Hodge). Another justification offered was the consistency of the rule with several well-established equitable doctrines such as "relief from forfeiture, the equity of redemption, and refusal to grant specific performance": [39] (Lord Neuberger and Lord Sumption).

<sup>12</sup> Fisher (n3) 175: "This case is unlikely to change the minds of those who think the penalty rule is irrational, arbitrary and overdue for abolition". See eg S Worthington, "Penalties and Agreed Damages Clauses" in G Virgo and S Worthington (eds), *Commercial Remedies: Resolving Controversies* (CUP, 2016) (forthcoming).

<sup>13</sup> *Makdessi* [12]-[14] (Lord Neuberger and Lord Sumption), [129] (Lord Mance) and [239] (Lord Hodge).

<sup>14</sup> *Makdessi* [13] (Lord Neuberger and Lord Sumption). Lord Hodge also adopted the requirement that the rule "applied only in relation to secondary obligations" ([241]).

<sup>15</sup> McGregor regarded this proposition as "self-evident": H McGregor, *McGregor on Damages*, 19th edn (Sweet & Maxwell, 2014) [15-009].

<sup>16</sup> In *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 (HL) 402, Lord Roskill stated the breach requirement expressly, but as Lord Mance put it "the facts of that case were quite

abandoned by the High Court of Australia.<sup>17</sup> The Supreme Court concluded that the breach requirement had strong historical roots originating in the equitable treatment of penal defeasible bonds,<sup>18</sup> and reflected the “fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach”.<sup>19</sup>

It follows from the breach requirement that the restated rule against penalties can still be “circumvented by careful drafting”.<sup>20</sup> Whilst acknowledging that there may be “capricious consequences of this state of affairs”,<sup>21</sup> the Supreme Court was ultimately unmoved by this objection.<sup>22</sup> Although the restriction might turn on a “somewhat formal distinction”, it was justified given that the rule was already an “inroad upon freedom of contract”.<sup>23</sup> Lord Mance was the only Justice to attempt a justification of the breach requirement in more than formalistic terms, denying that the requirement was “without rational or logical underpinning” and asserting instead that it reflected “a real distinction, legal and psychological”.<sup>24</sup>

The penalties rule can extend beyond “classic”<sup>25</sup> clauses requiring payment of money on breach. The application to other clauses had already been established in a piecemeal fashion by earlier authorities,<sup>26</sup> but *Makdessi* puts this proposition on a surer footing, both at the jurisdiction stage and by rejecting the genuine pre-estimate of loss test of validity.<sup>27</sup> It was a short step from the classic clause to accept that the penalties

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special”: *Makdessi* [129]. See also *Alder v Moore* [1961] 2 QB 57 (CA) 70-71 (Devlin LJ), dissenting; *Jervis v Harris* [1996] Ch 195 (CA) 206 (Millett LJ); *Imam-Sadeque* (n16) [191] (Popplewell J). In *Bridge v Campbell Discount Co Ltd* [1962] AC 600 (HL) 629-630, Lord Denning robustly rejected the breach requirement.

<sup>17</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 (HCA).

<sup>18</sup> *Makdessi* [13] and [42]. See also [241] (Lord Hodge). Lord Neuberger and Lord Sumption rebuffed the High Court of Australia’s contrary historical account of the penalties rule, holding ([42]) that “although the reasoning in *Andrews* was entirely historical, it is not in fact consistent with the equitable rule as it developed historically”.

<sup>19</sup> *Makdessi* [13].

<sup>20</sup> *Makdessi* [257] (Lord Hodge). See also [14] (Lord Neuberger and Lord Sumption).

<sup>21</sup> *Makdessi* [15] (Lord Neuberger and Lord Sumption).

<sup>22</sup> *Makdessi* [43] (Lord Neuberger and Lord Sumption), [130] and [162] (Lord Mance) and [258] (Lord Hodge). Cf *Bridge* (n16) 629 (Lord Denning): “Let no one mistake the injustice of this. It means that equity commits itself to this absurd paradox: it will grant relief to a man who breaks his contract but will penalise the man who keeps it”.

<sup>23</sup> *Makdessi* [43] (Lord Neuberger and Lord Sumption), citing *Else (1982) v Parkland Holdings* [1994] 1 BCAC 130 (CA) 145 (Hoffmann LJ).

<sup>24</sup> *Makdessi* [130].

<sup>25</sup> *Makdessi* [16] (Lord Neuberger and Lord Sumption).

<sup>26</sup> See eg *Gilbert Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689 (HL) 698 (Lord Reid), 703 (Lord Morris), 711 (Viscount Dilhorne) and 723 (Lord Salmon); *Jobson v Johnson* [1989] 1 WLR 1026 (CA) 1034-1035 (Dillon LJ) and 1042 (Nicholls LJ); *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573 (PC) 579 (Lord Browne-Wilkinson); *Else* (n23) 138 (Evans LJ); *General Trading Co (Holdings) Ltd v Richmond Corp Ltd* [2008] EWHC 1479 (Comm) [113] (Beatson J).

<sup>27</sup> *Makdessi* [222] (Lord Hodge). See further text to n132.

rule could, in principle, also apply to transfers (or re-transfers) of property upon breach.<sup>28</sup> Subject to the breach requirement, a clause withholding payments of money otherwise due to the contract-breaker can also potentially fall within the jurisdiction of the penalties rule.<sup>29</sup> The retention of a deposit paid as “surety” for performance may also be subject to the penalties rule,<sup>30</sup> although such clauses will not be invalid merely because they aimed to deter breach.<sup>31</sup>

## B. Unresolved issues

### i) Applying substance over form

*Makdessi* establishes that the breach requirement “depends on the substance of the term and not on its form or on the label which the parties have chosen to attach to it”.<sup>32</sup> However, the decision leaves the application of the substance over form test unresolved. The test potentially empowers judges to hold that a clause was substantially triggered by breach even though the clause was drafted (perhaps intentionally) to avoid creating a relevant obligation. On the other hand, the test must also be reconciled with the concession that the penalties rule can be circumvented by careful drafting.<sup>33</sup> Various approaches are possible. “Substance over form” may be understood as an application of the sham standard, or it may be subsumed within the ordinary process of contractual construction, or it may convey a more intrusive standard.

The first possibility would be to apply the sham standard. An agreement is a “sham” where *both parties* intend to give “the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create”.<sup>34</sup> However, applying this approach, the substance over form test would deny “circumvention by careful drafting” in the very circumstances where circumvention is least objectionable: that is, where both parties were deliberately aiming to avoid the penalties rule. The sham standard serves to

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<sup>28</sup> *Makdessi* [16] and [84] (Lord Neuberger and Lord Sumption), [170] and [183] (Lord Mance) and [230] and [233] (Lord Hodge).

<sup>29</sup> *Makdessi* [154]-[156] and [170] (Lord Mance) and [226] and [228] (Lord Hodge), with whom Lord Clarke and Lord Toulson agreed. Lord Neuberger and Lord Sumption were “prepared to assume, without deciding” this point: [73]. Cf [258], where Lord Hodge accepted that the penalties rule could be circumvented by redrafting a clause in terms of “instalments conditional upon performance”.

<sup>30</sup> *Makdessi* [16] (Lord Neuberger and Lord Sumption), [156] (Lord Mance) and [237]-[238] (Lord Hodge).

<sup>31</sup> See further text to n135.

<sup>32</sup> *Makdessi* [15] (Lord Neuberger and Lord Sumption), adding that one must establish “the real nature of the transaction” rather than “intention as expressed in the agreement”, citing *Bridge* (n16) 622 (Lord Radcliffe). See also *Makdessi* [258] (Lord Hodge).

<sup>33</sup> n20.

<sup>34</sup> *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 (CA) 802 (Diplock LJ) See further M Conaglen, “Sham Trusts” [2008] Cambridge Law Journal 176, 183-192.

protect specific public policy objectives that override freedom of contract; it is less well-suited to the penalties rule, which retains respect for freedom of contract as a relevant constraint on the jurisdiction of the rule.<sup>35</sup>

The second possibility would be to regard the substance over form test as part of the ordinary process of contractual construction. The test would then merely emphasise that the distinction between primary and secondary obligations is not determined exclusively by the literal wording of the clause.<sup>36</sup> In *Makdessi*, the construction approach appears to be reflected in Lord Neuberger and Lord Sumption's test of whether the clause in question creates "(expressly or impliedly) an obligation to perform".<sup>37</sup> On this view, a clause that initially appears to impose a conditional primary obligation may nevertheless be construed as a secondary obligation arising on breach, having regard to the whole contract and available background.<sup>38</sup>

Several cases prior to *Makdessi* exemplify the importance of construing the impugned clause in light of the contract as a whole. In *M & J Polymers v Imerys Minerals*, Burton J held that a "take or pay" clause fell within the jurisdiction of the penalties rule.<sup>39</sup> Although the conditions for payment under the clause were not expressed to be dependent on breach, they mirrored the obligations set out in another clause of the contract and thus substantially fell within the scope of the rule.<sup>40</sup> Similarly, in *General Trading v Richmond Corp*, Beatson J held that "The sale and purchase agreement in this case cannot be construed as a contract for the sale ... at two alternative prices" because "Such a construction is wholly inconsistent with the structure" of the other clauses in the contract.<sup>41</sup>

The concept of a "disguised penalty" may also be brought within the ordinary construction approach. This concept was first raised by Bingham LJ in *Interfoto Picture Library v Stiletto Visual Programmes*,<sup>42</sup> and was subsequently adopted by Lord Hodge in *Makdessi*.<sup>43</sup> Neither *Interfoto* nor *Makdessi* provide any detailed explanation of the concept. However, in *Euro London v Claessens International*, Chadwick LJ suggested that

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<sup>35</sup> *Makdessi* [13] (Lord Neuberger and Lord Sumption): "Leaving aside challenges going to the reality of consent ... the courts do not review the fairness of men's bargains".

<sup>36</sup> An analogous approach has been taken in relation to the designation of a clause as a "condition" for the purposes of termination: *Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235 (HL) 251-252 (Lord Reid), 258-229 (Lord Morris), 265 (Lord Simon) and 270-271 (Lord Kilbrandon).

<sup>37</sup> *Makdessi* [14] (emphasis added) (Lord Neuberger and Lord Sumption).

<sup>38</sup> *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 (HL) 912 (Lord Hoffmann).

<sup>39</sup> *M & J Polymers Ltd v Imerys Minerals Ltd* [2008] EWHC 344 (Comm), [2008] 1 CLC 276. Burton J also gave the example ([41]) that "a minimum payment clause in a hire purchase agreement can be held to be a penalty, even though expressed as a claim in debt".

<sup>40</sup> *M & J Polymers* (n39) [39]-[44]. Cf *Euro London Appointments Ltd v Claessens International Ltd* [2006] EWCA Civ 385, [2006] 2 Lloyd's Rep 436 [18]-[22] and [28] (Chadwick LJ).

<sup>41</sup> *General Trading* (n26) [116].

<sup>42</sup> *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433 (CA) 445-446.

<sup>43</sup> *Makdessi* [258].

"In referring to the clause as "a disguised penalty clause", Lord Justice Bingham was pointing out that, if that was the true nature of the bargain, the clause could not be taken outside the rule against penalties by presenting the charge as a "holding fee".<sup>44</sup> On this understanding, a "disguised penalty" merely reinforces the proposition that when construing the relevant clause, the parties' literal wording (taken in isolation) is not conclusive.

Under the ordinary process of construction, the scope of the penalties rule would nevertheless be constrained by the rule of interpretation that the court is bound to apply the parties' "unambiguous language".<sup>45</sup> In other words, if a clause was unambiguously drafted to ensure that it was not triggered by any breach of contract (even when read together with the other contractual terms) then it would be immune from the penalties rule. This approach fits with the proposition that the penalties rule can be circumvented by careful drafting. Indeed, without this constraint on the scope of judicial intervention, it is hard to see how the substance test can be reconciled with the concession in *Makdessi* that the breach requirement is essentially "formalistic in its application".<sup>46</sup>

The third possibility is that the substance over form test conveys a more intrusive standard. In *Makdessi*, Lord Hodge specified that parties could not circumvent the penalties rule where "the substance of the contractual arrangement is the imposition of punishment for breach of contract".<sup>47</sup> Similarly, Lord Neuberger and Lord Sumption held that if a clause was a "disguised punishment ... for breach, it would make no difference that it was expressed as part of the formula for determining the consideration".<sup>48</sup> These statements appear to go beyond anything one might recognise as part of the ordinary process of construction. They also blur the distinction between jurisdiction and validity, such that the question of punishment becomes relevant at both stages.<sup>49</sup> The concept of punishment is itself difficult to define.<sup>50</sup>

Previous authorities had alluded to a more intrusive substance over form test. In *OFT v Abbey National*, Lord Phillips held (obiter) that "the banks could not convert what were in effect penalties into "price" simply by wording their contracts so as to ensure that the contingencies that triggered liability to pay the charges did not constitute breaches of contract".<sup>51</sup> Similarly, in *Imam Sadeque v Bluebay Asset Management*, Popplewell J held that "It would not be possible to avoid the application of the [penalties

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<sup>44</sup> *Euro London* (n40) [27].

<sup>45</sup> *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, [2011] 1 WLR 2900 [23] (Lord Clarke); *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619 (Lord Neuberger) [17]-[20].

<sup>46</sup> *Makdessi* [40] (Lord Neuberger and Lord Sumption). See also [43].

<sup>47</sup> *Makdessi* [258].

<sup>48</sup> *Makdessi* [77].

<sup>49</sup> In relation to validity, see further text to n192.

<sup>50</sup> Text to n198.

<sup>51</sup> *Office of Fair Trading v Abbey National plc* [2009] UKSC 6, [2010] 1 AC 696 [83] (Lord Phillips). This point had "rightly" been conceded by Mr Sumption QC as counsel for the banks.

rule] by the simple expedient of making continued entitlement to a sum conditional on the absence of breach, if in substance what was achieved was forfeiture upon breach".<sup>52</sup> In both of these cases the court concluded that the clause was not substantially triggered by breach. However, they appear to envisage that it may sometimes be appropriate to look past the parties' unambiguous language.

The greater the scope for intrusion on grounds of substance, the more closely the restated English approach will come to resemble the jurisdictional test proposed by the High Court of Australia in *Andrews v Australia and New Zealand Banking Group*.<sup>53</sup> Lord Neuberger and Lord Sumption robustly rejected the Australian approach.<sup>54</sup> However, that test also rested on "a matter of substance", and although it referred to a "failure of the primary stipulation" rather than to "breach",<sup>55</sup> the Supreme Court acknowledged that this was a distinction without a difference.<sup>56</sup> If substance over form allows the English courts to look past the parties' unambiguous language, then despite the Supreme Court's protestations, there may be much less difference between the restated jurisdictional tests in England and Australia than initially assumed.<sup>57</sup>

## *ii) Distinguishing "conditional primary obligations"*

Although *Makdessi* settles that breach is a necessary requirement for establishing the jurisdiction of the penalties rule,<sup>58</sup> it also holds that breach is not sufficient. Previous authorities appeared to assume that if the impugned clause was conditional on breach then no further steps were required to satisfy the jurisdiction stage.<sup>59</sup> Rather than turning on breach, jurisdiction now turns on whether the clause imposed "a conditional primary obligation or a secondary obligation providing a contractual alternative to damages at law".<sup>60</sup> Obligations that are created, varied or extinguished by breach may thus fall outside the scope of the penalties rule if they can be construed as conditional primary obligations.<sup>61</sup> However, the new distinction between conditional primary

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<sup>52</sup> *Imam-Sadeque* (n16) [203] (Popplewell J), citing *Clydebank* (n52) 15.

<sup>53</sup> *Andrews* (n17).

<sup>54</sup> *Makdessi* [42] (Lord Neuberger and Lord Sumption).

<sup>55</sup> *Andrews* (n17) [10].

<sup>56</sup> *Makdessi* [42] (Lord Neuberger and Lord Sumption), arguing that the High Court of Australia's "analysis assumes that the "primary stipulation" is some kind of promise, in which case its failure is necessarily a breach of that promise".

<sup>57</sup> See further text to n68.

<sup>58</sup> Text to n13.

<sup>59</sup> See eg *Jervis* (n16) 206 (Millett LJ); *Euro London* (n40) [27] (Chadwick LJ), discussing the "holding fee" clause in *Interfoto* (n42); *M & J Polymers* (n39) [41] (Burton J); *Imam-Sadeque* (n16) [187] (Popplewell J).

<sup>60</sup> *Makdessi* [14] (Lord Neuberger and Lord Sumption). See also [32] and [73] (Lord Neuberger and Lord Sumption). Lord Hodge also agreed with this distinction in principle ([241]).

<sup>61</sup> *Makdessi* [14] (Lord Neuberger and Lord Sumption) and [270] (Lord Hodge).

obligations and secondary obligations creates new uncertainties and leaves several existing issues unresolved.

The definition of a “secondary obligation” is now key to the application of the jurisdiction stage. The conventional view, introduced into English law by Diplock LJ,<sup>62</sup> was that “breaches of primary obligations give rise to substituted or secondary obligations”.<sup>63</sup> On this view, secondary obligations are remedies imposed by law. In *Makdessi*, the Supreme Court departed from this understanding but equivocated over its own definition.<sup>64</sup> The Justices re-characterised secondary obligations as “security for performance”,<sup>65</sup> and ““collateral” or “accessorial” to the primary obligation”.<sup>66</sup> But the judgments also refer to the conventional remedial understanding.<sup>67</sup> The aim was evidently to refashion a test that excluded clauses conditional on breach where the relevant obligation was particularly central to the bargain; by contradistinction, “secondary obligation” now effectively means “ancillary obligation”, rather than specifically a remedial term.

Both the English and Australian approaches to jurisdiction have now moved away from the relatively simple test of whether the clause was triggered by breach. In *Andrews*, the High Court of Australia sought to expand the jurisdiction of the penalties rule beyond clauses triggered by breach. In *Makdessi*, the Supreme Court’s restatement had the opposite motivation; it sought to narrow the jurisdictional test to exclude some types of clause triggered by breach. However, the resulting formulations are strikingly similar. In Australia, jurisdiction now turns on whether the clause was a “collateral or accessory stipulation … in the nature of a security” for performance of the primary stipulation.<sup>68</sup> This formulation is almost indistinguishable from the Supreme Court’s re-characterisation of a secondary obligation.<sup>69</sup> In light of this, Lord Neuberger and Lord Sumption should perhaps not have been so quick to denigrate the Australian test.<sup>70</sup>

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<sup>62</sup> *Czarnikow Ltd v Koufos (The Heron II)* [1966] 2 QB 695 (CA) 731-732; *Robophone* (n62) 1446; *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 (HL) 848. The terminology of “primary” and “secondary” rights and obligations was originally introduced to English jurisprudence in J Austin, *Lectures on Jurisprudence or the Philosophy of Positive Law*, vol 2, 5th edn (R Campbell ed, London: Murray, 1885) 762-763; see further B Dickson, “The Contribution of Lord Diplock to the General Law of Contract” (1989) 9 O.J.L.S. 441.

<sup>63</sup> *Photo Production* (n62) 848.

<sup>64</sup> As Conte (n3) concludes, “the court’s distinction between primary and secondary obligations does not work”: 385.

<sup>65</sup> *Makdessi* [7] (Lord Neuberger and Lord Sumption). See also [251] (Lord Hodge): “an additional means of enforcement”.

<sup>66</sup> *Makdessi* [13] (Lord Neuberger and Lord Sumption), citing *Sloman v Walter* (1783) 1 Brown's Chancery Cases 418, 28 ER 1213, 1214 (Thurlow LC).

<sup>67</sup> *Makdessi* [74] (Lord Neuberger and Lord Sumption): “contractual alternative to damages at law”; and [241] (Lord Hodge): “remedies for breach of contract”.

<sup>68</sup> *Andrews* (n17) [10].

<sup>69</sup> n65 and n66. See also text to n55.

<sup>70</sup> *Makdessi* [42].

An important issue left unresolved by the restated jurisdiction test concerns clauses that impose or vary obligations on the contract-breaker as a result of breach. *Makdessi* holds that clauses stipulating “the consideration promised for a given standard of performance” are now outside the penalties rule because they “define the primary obligations of the parties”.<sup>71</sup> This proposition leaves open a new approach to cases like *Lordsvale Finance v Bank of Zambia*,<sup>72</sup> where the clause uplifted the interest rate for future loan repayments following a default by the borrower. Colman J assumed that the clause was within the jurisdiction of the penalties rule, although he held that the clause was not invalid because it was commercially justified.<sup>73</sup> However, such clauses may now fall outside the scope of the penalties rule altogether, if they can be characterised as varying the primary obligation to repay the loan.

This reanalysis of the *Lordsvale* uplift clause as a conditional primary obligation finds some support from Lord Mance’s judgment in *Makdessi*. Lord Mance reasoned that “In substance, the uplift amounts to a variation of the original terms”, even though the “uplift is conditioned on the breach”,<sup>74</sup> because “the breach reflects directly upon the continuing appropriateness of the originally agreed interest terms”.<sup>75</sup> Although these considerations point to the characterisation of the clause as a conditional primary obligation, they were raised in relation to validity rather than jurisdiction.<sup>76</sup> It therefore appears that Lord Mance may have regarded the *Lordsvale* clause as *within* the jurisdiction of the penalties rule *even though* it was a conditional primary obligation.<sup>77</sup> Lord Mance’s position on the status of conditional primary obligations is unclear because his judgment does not distinguish between jurisdiction and validity, or between primary and secondary obligations.

The *Lordsvale* example demonstrates that although the separation of jurisdiction and validity provides a useful analytical tool, in practice there may be some overlap between the criteria relevant at each stage. In relation to uplift clauses, if the amount of the uplift triggered by breach is relatively small then it may be plausible to regard the clause as a renegotiation of the price of the loan, based on the change to the borrowers’ credit risk; for the same reason, the clause would probably be valid even if it fell within

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<sup>71</sup> *Makdessi* [73] (Lord Neuberger and Lord Sumption). See also [270] (Lord Hodge).

<sup>72</sup> *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752.

<sup>73</sup> *Lordsvale* (n72) 763-774. On commercial justification, see further text to n136.

<sup>74</sup> *Makdessi* [148].

<sup>75</sup> *Makdessi* [148]. See also *United International Pictures v Cine Bes Filmcilik ve Yapimcilik AS* [2003] EWCA Civ 1669, [2004] 1 CLC 401, where the clause may be construed as imposing “terms of settlement which provide on default for payment of costs which a party was prepared to forego if the settlement was honoured”: *Makdessi* [152] (Lord Mance). Again, in *Cine Bes* itself, the Court of Appeal assumed that the clause was within the jurisdiction of the penalties rule.

<sup>76</sup> *Makdessi* [153], holding that such clauses would be upheld “Provided that “interest” protected or “in due performance” is understood widely enough to cover an interest in renegotiating the original contractual bargain”; these factors refer to the test for validity rather than jurisdiction.

<sup>77</sup> This also appears to have been Lord Mance’s position in relation to the two clauses under consideration in the *Makdessi* appeal itself: see further n99 and n100.

the jurisdiction of the penalties rule. Conversely, if the amount of the uplift is very large then it may be less plausible to regard the clause as merely renegotiating the price; for the same reason, the clause is also likely to be regarded as exorbitant at the validity stage. In other words, in practice the proportionality of a clause may be relevant at the jurisdiction as well as the validity stage.<sup>78</sup>

Another important issue left unresolved concerns clauses that extinguish or vary the innocent party's obligations as a result of breach. The main difficulty arises in relation to conditions that have "retrospective" effect, by extinguishing or diminishing obligations that have already accrued to the contract-breaker. Such clauses are more controversial than those which operate prospectively to prevent obligations that have not yet accrued. In *Makdessi*, Lord Neuberger and Lord Sumption conflated these two types of condition in their proposition that "If as a result [of breach] remuneration is reduced upon his non-performance, there is no reason to regard that outcome as penal".<sup>79</sup> Their analysis suggests that clauses reducing the remuneration payable to the contract-breaker are outside the scope of the penalties rule regardless of whether the clause operates prospectively or retrospectively.

It was already established in English law that clauses preventing the prospective accrual of obligations are outside the jurisdiction of the penalties rule, even where failure of the relevant condition coincides with a breach of contract. In *Euro London*, Chadwick LJ declined to apply the penalties rule to clauses that defined the circumstances in which the right to a refund arose, reasoning that "they do not defeat the right to refund when it arises, nor any other existing right to refund".<sup>80</sup> Popplewell J reached the same conclusion in *Imam-Sadeque*, holding that "The effect was not that the terms ... provided for the forfeiture of his shares by reason of breaches of [the contract]. The effect was that he never acquired the rights identified".<sup>81</sup> In other words, the penalties rule was inapplicable because the impugned clause "conferred a conditional benefit ... which never accrued because he failed to fulfil the condition".<sup>82</sup>

In *Makdessi*, Lord Neuberger and Lord Sumption put forward the more controversial proposition that conditional primary obligations may be outside the jurisdiction of the penalties rule even if the clause retrospectively cancels obligations that have already accrued. They gave the example of a "retrospective cesser" clause in an insurance contract, which "forfeited an accrued right to indemnity permanently" where

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<sup>78</sup> On proportionality, see further text to n148.

<sup>79</sup> *Makdessi* [73]. See also [73]: "the consideration due to [the contract-breaker] may be variable according to one or more contingencies, including the contingency of his breach of the contract".

<sup>80</sup> *Euro London* (n40) [28].

<sup>81</sup> *Imam-Sadeque* (n16) [207].

<sup>82</sup> *Imam-Sadeque* (n16) [208].

the insured breached certain obligations.<sup>83</sup> Lord Neuberger and Lord Sumption suggested that such clauses may fall outside the penalties rule if they determine “the consideration promised for a given standard of performance” and thus “define the primary obligations of the parties”.<sup>84</sup> In proposing this test, the Justices did not draw any distinction between the retrospective cesser clause and the separate class of cases where the relevant obligation had not yet accrued.<sup>85</sup>

The exclusion of retrospective conditions from the jurisdiction of the penalties rule is doubtful as a matter of previous authority. Lord Neuberger and Lord Sumption’s approach relied solely on a comment by Bingham LJ in *The Padre Island*;<sup>86</sup> however, Bingham LJ was in the minority on this point,<sup>87</sup> which was also obiter dictum.<sup>88</sup> On the contrary, in *Gilbert Ash v Modern Engineering*, the House of Lords assumed that a clause fell within the penalties rule where it allowed the innocent party to “withhold payment of any monies due or becoming due”, including payment obligations that had already accrued to the contract-breaker.<sup>89</sup> That assumption was approved by Lord Mance and Lord Hodge in *Makdessi*.<sup>90</sup> The Supreme Court was therefore divided on the issue of retrospective effect. It seems likely that conditional primary obligations will only be excluded from the penalties rule where the condition operates prospectively.

If the foregoing analysis is correct, the restated jurisdiction test will still turn on a further distinction “between contingent rights and accrued rights”.<sup>91</sup> This distinction may be difficult to draw in complex transactions. For example, in *Imam-Sadeque*, Popplewell J concluded that although the contract-breaker had an accrued beneficial interest in the relevant property, he only had a contingent right to the legal title.<sup>92</sup> In *Makdessi* itself, Clause 5.1 was construed to have only prospective effect, such that it would “only result in the loss of either Payment, if the breach occurs before the payment is due”.<sup>93</sup> However, this construction was not entirely obvious; the wording of the clause

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<sup>83</sup> *Makdessi* [73], citing *Socony Mobil Oil Co Inc v The West of England Ship Owners Mutual Insurance Association Ltd (The Padre Island), sub nom Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* [1989] 1 Lloyd's Rep 239 (CA).

<sup>84</sup> *Makdessi* [73] (Lord Neuberger and Lord Sumption).

<sup>85</sup> See eg *Else* (n23), discussed in *Makdessi* [72].

<sup>86</sup> *The Padre Island* (n83) 254 (Bingham LJ).

<sup>87</sup> *The Padre Island* (n83) 262 (Stuart-Smith LJ) and 265 (O'Connor LJ).

<sup>88</sup> On the dispositive issue, the Court of Appeal’s decision was subsequently overturned by the House of Lords: [1991] 2 AC 1 (HL).

<sup>89</sup> *Gilbert Ash* (n26) 698 (Lord Reid), 703 (Lord Morris), 711 (Viscount Dilhorne) and 723 (Lord Salmon). This point was conceded by counsel. The decision in *Giraud UK Ltd v Smith* [2000] IRLR 763 (EAT) also reflects this assumption. Both cases are discussed in *Imam-Sadeque* (n16) [219] (Popplewell J).

<sup>90</sup> *Makdessi* [154]-[155] (Lord Mance) and [226] (Lord Hodge). Lord Mance also doubted Lord Neuberger and Lord Sumption’s interpretation of Bingham LJ’s reasoning in *The Padre Island* (n83) [155].

<sup>91</sup> *Imam-Sadeque* (n16) [220].

<sup>92</sup> *Imam-Sadeque* (n16) [211]-[212].

<sup>93</sup> *Makdessi* [176] (Lord Mance). See also *Makdessi v Cavendish Square Holdings BV* [2013] EWCA Civ 1540 [18] (Christopher Clarke LJ).

seems to have been wide enough to encompass payments that had already accrued but had not yet been paid at the date of breach.<sup>94</sup> In principle, the status of an impugned clause must be determined as a matter of construction at the date of contract formation rather than in light of events as they subsequently transpired.<sup>95</sup>

So, where are we now? *Makdessi* replaces the relatively straightforward breach requirement with an elusive distinction between conditional primary obligations and secondary obligations (where “secondary obligation” does not bear its conventional meaning). Some clauses that were previously within the jurisdiction of the penalties rule – such as the *Lordsvale* uplift clause,<sup>96</sup> or clauses with retrospective effect<sup>97</sup> – may arguably now fall outside the rule. The new distinction narrows the scope of jurisdiction, which may increase parties’ certainty that their clauses will be enforced; however, the jurisdiction test itself is less certain than before. To support this proposition, one need only look to the application of the restated test in *Makdessi*: even though the Justices were essentially agreed as to the applicable legal test,<sup>98</sup> they reached no clear majority on one of the clauses under examination,<sup>99</sup> and on the other they were split four to three.<sup>100</sup>

### *iii) “Retention” clauses*

*Makdessi* leaves open several issues concerning clauses that enable the innocent party to retain property or money upon breach. A retention clause may provide for the retention of property, a “deposit”, or instalments of the price. The approaches to these three types of retention clause are very difficult to reconcile. Retention of property clauses fall outside the jurisdiction of the penalties rule; by contrast, *Makdessi* establishes that “deposit” clauses fall within the rule.<sup>101</sup> The status of clauses providing for the retention

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<sup>94</sup> Clause 5.1 reads: “If a Seller becomes a Defaulting Shareholder he shall not be entitled to receive the Interim Payment and/or the Final Payment which would otherwise than for his having become a Defaulting Shareholder have been paid to him and the Purchaser’s obligations to make such payment shall cease”.

<sup>95</sup> n182 and n183.

<sup>96</sup> Text to n72.

<sup>97</sup> Text to n83.

<sup>98</sup> n60.

<sup>99</sup> Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) held that Clause 5.1 was outside the jurisdiction of the penalties rule: [74]. Lord Hodge (with whom Lord Toulson and Lord Clarke agreed), expressly left the issue open: [270], [291] and [292]. Lord Mance’s view was unclear because although he held that the clause amounted “to a reshaping of the parties’ primary relationship” ([183]), he also applied the validity test without any indication that this stage was superfluous ([181]).

<sup>100</sup> Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) held that Clause 5.6 was outside the jurisdiction of the penalties rule: [83]. Lord Hodge (with whom Lord Toulson and Lord Clarke agreed) held that the clause was covered by the penalties rule: [280], [291] and [292]. Lord Mance’s view was again unclear, but he appears to have accepted that it was appropriate to apply the validity test ([183]).

<sup>101</sup> n30.

of instalments of the price remains uncertain. The restated approach may create a difficult distinction between deposit and instalment clauses, both of which involve the retention of money upon breach. The Supreme Court's analysis of retention clauses overlooks a potentially significant distinction between repudiatory and non-repudiatory breaches.

The status of retention of property clauses is illustrated by two Court of Appeal decisions in *Jobson v Johnson* and *Else (1982) v Parkland Holdings*.<sup>102</sup> Both of these cases loosely concerned the forfeiture of shares following a default by the buyer. In *Jobson*, the shares had already been transferred to the buyer (and the clause provided for re-transfer), whereas in *Else*, the shares had remained the property of the seller (and the clause provided for retention). The penalties rule extended to the re-transfer clause in *Jobson*,<sup>103</sup> but not to the retention clause in *Else*.<sup>104</sup> In *Makdessi*, Lord Mance concluded from this distinction that although clauses requiring the contract-breaker to re-transfer property to the innocent party may fall within the jurisdiction of the penalties rule,<sup>105</sup> the rule does not cover clauses that provide for retention of property already owned by the innocent party on breach.<sup>106</sup>

In *Else*, Evans LJ explained this approach on the basis that "a case where both the legal and beneficial property has passed to the purchaser is conceptually different" to one in which "the legal interest in the shares had been retained by the plaintiffs until the defendants' payment obligations were discharged".<sup>107</sup> Although admittedly based on a "formal distinction",<sup>108</sup> this treatment of retention of property clauses can now be understood in terms of a (prospective) conditional primary obligation:<sup>109</sup> the accrual of the obligation to transfer the property to the buyer is conditional on counter-performance. However, it follows from the central distinction between conditional primary obligations and secondary obligations that if the retention of property clause can be construed as "a mere security for performance"<sup>110</sup> then it may still fall within the jurisdiction of the penalties rule.

The restated approach to "deposit" clauses is difficult to reconcile with the retention of property cases and may now raise the further issue of how to distinguish between deposits and instalments of the price. *Makdessi* confirms that deposit clauses

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<sup>102</sup> *Jobson* (n26).

<sup>103</sup> *Jobson* (n26) 1031-1032 (Dillon LJ) and 1043-1044 (Nicholls LJ).

<sup>104</sup> *Else* (n23) 136 (Evans LJ) and 144 (Hoffmann LJ).

<sup>105</sup> N28. Cf *Makdessi* [16] (Lord Neuberger and Lord Sumption), which appears to cast doubt on this proposition for proprietary or possessory rights "granted or transferred subject to revocation or determination on breach".

<sup>106</sup> *Makdessi* [157] and [159].

<sup>107</sup> *Else* (n23) 138 (Evans LJ).

<sup>108</sup> *Else* (n23) 145 (Hoffmann LJ).

<sup>109</sup> See further text to n60 and n80.

<sup>110</sup> N65.

are within the jurisdiction of the penalties rule: “the fact that a sum is paid over by one party to the other party as a deposit, in the sense of some sort of surety for the first party’s contractual performance, does not prevent the sum being a penalty”.<sup>111</sup> Although this conclusion is consistent with previous authority,<sup>112</sup> it is difficult to reconcile with the approach to property in *Else*,<sup>113</sup> because in deposit cases the payment occurs before the breach such that the deposit clause merely provides for retention rather than transfer of the payment upon breach.<sup>114</sup>

The status of clauses that enable a seller to retain instalments of price remains unresolved. In *Makdessi*, Lord Neuberger and Lord Sumption concluded that unlike deposits, “retention of instalments which have been paid under contract so as to become the absolute property of the vendor does not fall within the penalty rule”.<sup>115</sup> However, this point was not finally resolved because two of the other Justices expressly reserved judgment.<sup>116</sup> Previously in *Else*, the Court of Appeal concluded that a clause providing for the retention of instalments was outside the jurisdiction of the penalties rule.<sup>117</sup> On the other hand, several earlier authorities appear to hold that such clauses may be classified as penalties, although the form of relief awarded suggests that the courts may have applied relief against forfeiture even though they adopted the terminology of a penalty.<sup>118</sup> These authorities were largely overlooked in *Makdessi*.<sup>119</sup>

The main basis for distinguishing between deposits and instalments of the price appears to be that, unlike instalments, deposits are paid “as security for due performance” and therefore constitute a “secondary obligation”.<sup>120</sup> A related distinction may be that deposits are not transferred to the seller “absolutely”.<sup>121</sup> However, as

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<sup>111</sup> *Makdessi* [16]. See also [156] (Lord Mance) and [238] (Lord Hodge).

<sup>112</sup> *Commissioner of Public Works v Hills* [1906] AC 368 (PC) 375-376 (Lord Dunedin); *Workers Trust* (n26) [1993] AC 573 (PC) 579 (Lord Browne-Wilkinson).

<sup>113</sup> n107.

<sup>114</sup> As Conte (n3) argues, “A depositor will forfeit nothing on breach. X cannot forfeit the right to the deposit payment, as X transfers that right to Y before X breaches the contract”: 386.

<sup>115</sup> *Makdessi* [16], citing *Else* (n23) 146 (Hoffmann LJ) and *Stockloser v Johnson* [1954] 1 QB 476 (CA). See also *Cadogan Petroleum Holdings Ltd v Global Process Systems LLC* [2013] EWHC 214 (Comm), [2013] 2 Lloyd's Rep 26 [33] (Eder J), cited in *Makdessi* [156] (Lord Mance). Lord Neuberger and Lord Sumption clarified that a retention of instalment clause may nevertheless be subject to relief against forfeiture: *Makdessi* [16].

<sup>116</sup> *Makdessi* [156] and [170] (Lord Mance) and [229] (Lord Hodge).

<sup>117</sup> *Else* (n23) 136 (Evans LJ) and 144 (Hoffmann LJ).

<sup>118</sup> *Re Dagenham (Thames) Dock Co Ex p Hulse* (1872-73) LR 8 Ch App 1022 (CA); *Kilmer v British Columbia Orchard Lands Ltd* [1913] AC 319 (PC) 325 (Lord Moulton); *Steedman v Drinkle* [1916] 1 AC 275 (PC) 279 (Viscount Haldane).

<sup>119</sup> Lord Neuberger and Lord Sumption ([42]) did acknowledge the decision in *Re Dagenham (Thames) Dock Co Ex p Hulse* (1872-73) LR 8 Ch App 1022 (CA) but they sought to distinguish it as a case of relief against forfeiture.

<sup>120</sup> *Else* (n23) 146 (Hoffmann LJ), cited in *Makdessi* [16] (Lord Neuberger and Lord Sumption).

<sup>121</sup> *Stockloser* (n115) 489 (Denning LJ); *Else* (n23) 146 (Hoffmann LJ).

Hoffmann LJ acknowledged in *Else*, “It may sometimes be hard to say whether a contract is providing for forfeiture of money paid absolutely or for a penal liability which is being set off against money due”.<sup>122</sup> In practice, the primary way of differentiating between deposits and instalments may be by reference to the size of the sum retained.<sup>123</sup> Consequently, if the distinction drawn by Lord Neuberger and Lord Sumption is correct, it further illustrates that in practice the proportionality of the stipulation is likely to be relevant at the jurisdiction as well as the validity stage.<sup>124</sup>

The Supreme Court’s analysis of retention clauses overlooks a potentially significant distinction between repudiatory and non-repudiatory breaches. This distinction concerns the legal position that would obtain in the absence of the clause. In *Else*, Evans LJ reasoned that in considering jurisdiction over the impugned clauses (which provided for the retention of both property and instalments of the price), it was necessary to take account of “the right which an unpaid vendor has, or may have, to rescind (meaning to terminate) the contract of sale if the buyer commits a repudiatory breach”.<sup>125</sup> On the facts, the clauses were “no more than an express statement of what in any event would have been [the innocent party’s] right to rescind the contract”.<sup>126</sup> The retention clauses thus fell outside the penalties rule because they did not affect the legal position that would have obtained anyway under the common law.

The explanation put forward in *Else* leaves open whether retention clauses may be characterised differently where they enable the seller to retain property or money in response to a non-repudiatory breach. However, other authorities do not appear to recognise this distinction. In *Imam-Sadeque*, Popplewell J held that the impugned clause was outside the penalties rule even though it allowed for the retention of property for a non-repudiatory breach.<sup>127</sup> This approach goes further than the reasoning in *Else* because the innocent party would not have been able to retain the property at common law in the absence of any right to terminate the contract.<sup>128</sup> In *Lombard North Central v Butterworth*, Mustill LJ held that the penalties rule did not cover clauses that expressly designate minor obligations as “conditions”,<sup>129</sup> even though such clauses may be functionally equivalent to retention clauses in that they create a right to terminate for breaches that would otherwise be non-repudiatory.

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<sup>122</sup> *Else* (n23) 146 (Hoffmann LJ).

<sup>123</sup> Another way may be by reference to the timing of the payment relative to other payments.

<sup>124</sup> See also text following n77. On proportionality, see further text to n148.

<sup>125</sup> *Else* (n23) 136.

<sup>126</sup> *Else* (n23) 144.

<sup>127</sup> *Imam-Sadeque* (n16) [224]. Popplewell J also refused to “read down” the clause such that it covered only repudiatory breaches.

<sup>128</sup> In other words, the contract-breaker could still have completed performance and thereby secured the accrual of the right to receive the property.

<sup>129</sup> *Lombard North Central Plc v Butterworth* [1987] QB 527 (CA) 537.

### III. VALIDITY

#### A. What we know

We now know that validity does not depend on establishing that the stipulated sum (or other consequence) was compensatory: “A damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach”.<sup>130</sup> In particular, “commercial interests may justify the imposition upon a breach of contract of a financial burden which cannot either be related directly to loss caused by the breach or justified by reference to the impossibility of assessing such loss”.<sup>131</sup> This conclusion entailed a rejection of the dichotomy between a genuine pre-estimate of loss and a penalty.<sup>132</sup> The modern preoccupation with the genuine pre-estimate of loss test had mistakenly developed from a “quasi-statutory”<sup>133</sup> interpretation of Lord Dunedin’s test in *Dunlop Pneumatic Tyre v New Garage & Motor Co Ltd*.<sup>134</sup>

We now also know that a clause may be valid even though it aimed to deter breach.<sup>135</sup> Although previous authorities had sometimes departed from the genuine pre-estimate of loss test where the clause was “commercially justified”,<sup>136</sup> it was widely held that a clause would be invalid if “the predominant contractual function of the provision was to deter”.<sup>137</sup> In *Makdessi*, the Supreme Court held that this understanding rested on another false dichotomy between commercial justification and deterrence.<sup>138</sup> A majority emphasised that deterrent clauses were not “inherently penal or contrary to the policy of the law”<sup>139</sup> because they were “simply one species of provision designed to influence

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<sup>130</sup> *Makdessi* [28] (Lord Neuberger and Lord Sumption). See also [23].

<sup>131</sup> *Makdessi* [145] (Lord Mance). See also [143] and [152].

<sup>132</sup> *Makdessi* [225] (Lord Hodge). Lord Neuberger and Lord Sumption referred to previous authorities as “the prisoner of artificial categorisation”: [31]. See also [145] and [152] (Lord Mance).

<sup>133</sup> *Makdessi* [22] (Lord Neuberger and Lord Sumption).

<sup>134</sup> *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 (HL) 87-88. The weight placed on Lord Dunedin’s judgment was unwarranted: *Makdessi* [21]-[24] (Lord Neuberger and Lord Sumption), [135]-[139] (Lord Mance) and [220]-[221] (Lord Hodge).

<sup>135</sup> On the facts of the *Makdessi* and *ParkingEye* appeals, the Supreme Court unanimously held that all of the clauses under examination were valid despite that they aimed to deter breach.

<sup>136</sup> *Lordsvale* (n72) 763-764 (Colman J); *Cine Bes* (n75) [15] (Mance LJ), *Murray v Leisureplay plc* [2005] EWCA Civ 963, [2005] IRLR 946 [46] (Arden LJ), [106] (Clarke LJ) and [117] (Buxton LJ); *Imam-Sadeque* (n16) [196] (Popplewell J).

<sup>137</sup> *Lordsvale* (n72) 762 (Colman J), cited with approval in: *Cine Bes* (n75) [13] (Mance LJ); *Murray* (n136) [106] (Clarke LJ) and [110] (Buxton LJ). See also *Imam-Sadeque* (n16) [189] (Popplewell J). In *Makdessi v Cavendish Square Holdings BV* [2013] EWCA Civ 1540 [120]-[121] (Christopher Clarke LJ), this reasoning led the Court of Appeal to conclude that both clauses were invalid.

<sup>138</sup> *Makdessi* [31] (Lord Neuberger and Lord Sumption) and [221] (Lord Hodge). See also [28] (Lord Neuberger and Lord Sumption), arguing that deterrence and commercial justification may coincide.

<sup>139</sup> *Makdessi* [31] (Lord Neuberger and Lord Sumption). See also [285] (Lord Hodge). Lord Mance’s position was less clear: he appeared to suggest that a clause may be invalid if it is “in its nature a

the conduct of the party potentially affected".<sup>140</sup> This approach explains why deposit clauses, which overtly serve to enforce performance (and thereby to deter breach), may nevertheless pass the validity test.<sup>141</sup>

The restated test for validity now centres on the interrelated concepts of legitimate interest, exorbitance and unconscionability. On this approach, "The true test 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 the primary obligation".<sup>142</sup> An important implication of the restated test, compared with the previous understanding, is that "deterrence is not penal if there is a legitimate interest in influencing the conduct of the contracting party which is not satisfied by the mere right to recover damages".<sup>143</sup> The legitimate interest test was said to be supported by the early authorities on penalties,<sup>144</sup> most notably by Lord Atkinson's reasoning in *Dunlop*, which was based on "the innocent party's interest in the performance of the relevant obligation".<sup>145</sup>

The courts must also apply a supplementary test involving the concepts of exorbitance and unconscionability.<sup>146</sup> The test is "whether, assuming [a legitimate] interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable".<sup>147</sup> The assessment of exorbitance and unconscionability will depend on the proportionality of the stipulation compared with the innocent party's legitimate interests.<sup>148</sup> In applying this test, the court should not impose "too stringent a standard".<sup>149</sup> Extravagance, exorbitance and unconscionability will usually amount to the same thing.<sup>150</sup> If this is correct, the myriad of terms all effectively depend on the concept of disproportionality. The only firm outer boundary of validity concerns clauses that aim to punish the contract-breaker, because "The innocent

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punishment for or deterrent to breach" ([148]) but nevertheless upheld the clause in the *ParkingEye* appeal despite expressly acknowledging that it was intended to have a "deterrent element" ([198]).

<sup>140</sup> *Makdessi* [31]. See also [248] (Lord Hodge).

<sup>141</sup> *Makdessi* [16] (Lord Neuberger and Lord Sumption) and [234] (Lord Hodge).

<sup>142</sup> *Makdessi* [32]. See also [28], requiring "a legitimate interest in performance extending beyond the prospect of pecuniary compensation".

<sup>143</sup> *Makdessi* [99].

<sup>144</sup> *Makdessi* [23]-[24], citing *Clydebank* (n52) 19-20 (Lord Robertson); *Dunlop* (n134) 92 (Lord Atkinson).

<sup>145</sup> *Makdessi* [23] (Lord Neuberger and Lord Sumption), citing *Dunlop* (n134) 91-92 (Lord Atkinson). See also [137] and [179] (Lord Mance).

<sup>146</sup> *Makdessi* [31] (Lord Neuberger and Lord Sumption), [162] (Lord Mance) and [244] (Lord Hodge). These terms appear to originate in *Clydebank* (n52) 10 (Lord Halsbury) and were adopted in *Dunlop* (n134) 87 (Lord Dunedin), 95 (Lord Atkinson) and 101 (Lord Parmoor).

<sup>147</sup> *Makdessi* [152] (Lord Mance). See also [255] (Lord Hodge) and [293] (Lord Toulson).

<sup>148</sup> *Makdessi* [249] and [255]. See also [32] (Lord Neuberger and Lord Sumption): "out of all proportion".

<sup>149</sup> *Makdessi* [248].

<sup>150</sup> *Makdessi* [31] (Lord Neuberger and Lord Sumption), [152] (Lord Mance) and [293] (Lord Toulson).

party can have no proper interest in simply punishing the defaulter".<sup>151</sup> In other words, punishment will always be disproportionate.

## B. Unresolved issues

### i) The scope of "legitimate interest"

The concept of "legitimate interest" now features in several doctrines in the law of damages. In relation to the tests for recovery of the agreed sum,<sup>152</sup> the availability of specific performance,<sup>153</sup> and the exceptional imposition of disgorgement damages,<sup>154</sup> its application has proved far from straightforward. *Makdessi* alludes only briefly to these other doctrines;<sup>155</sup> it appears that the legitimate interest test as applied to the penalties rule is essentially freestanding. Although the Supreme Court sought to ground the restated test in the early authorities on penalties,<sup>156</sup> guidance on the scope of legitimate interest is likely to be derived mainly if not exclusively from its application to the *Makdessi* and *ParkingEye* appeals themselves. These appeals reveal several unresolved issues.

The first main issue is: legitimate interest in what? A majority of the Supreme Court referred to the "legitimate interest of the innocent party in the enforcement of the primary obligation".<sup>157</sup> Such interests need not be commercial.<sup>158</sup> On this approach, not only does the penalties rule now permit an interest in deterrence, it affirmatively grounds the relevant interest in the aim of deterring breach. In other words, it recasts valid clauses as prophylactic enforcements of primary obligations rather than as an agreed remedies for breach. This approach flips the old understanding on its head.<sup>159</sup>

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<sup>151</sup> *Makdessi* [32]. See also [31]: "The real question when a contractual provision is challenged as a penalty is whether it is penal".

<sup>152</sup> *White & Carter (Councils) Ltd v McGregor* [1962] AC 413 (HL) 431 (Lord Reid); *Isabella Shipowner SA v Shagang Shipping Co Ltd (The Aquafait)* [2012] EWHC 1077 (Comm), [2012] 2 All ER (Comm) 461 [9]-[26] (Cooke J).

<sup>153</sup> *Cooperative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1998] AC 1 (HL) 18 (Lord Hoffmann).

<sup>154</sup> *Attorney General v Blake* [2001] 1 AC 268 (HL) 285 (Lord Nicholls) and 293 (Lord Hobhouse); *Experience Hendrix LLC v PPX Enterprises Inc* [2003] EWCA Civ 323, [2003] 1 All ER (Comm) 830 [35] (Mance LJ).

<sup>155</sup> *Makdessi* [29]-[30] (Lord Neuberger and Lord Sumption).

<sup>156</sup> N144.

<sup>157</sup> *Makdessi* [32] (Lord Neuberger and Lord Sumption) and [28], requiring "a legitimate interest in performance extending beyond the prospect of pecuniary compensation". See also [255] (Lord Hodge), with whom Lord Toulson expressly agreed on this point): referring to "the innocent party's interest in the performance of the contract".

<sup>158</sup> *Makdessi* [249] (Lord Hodge).

<sup>159</sup> See eg *Imam-Sadeque* (n16) [202] (Popplewell J): "A penalty clause is a clause which, without commercial justification ... [is] designed to secure performance of the contract rather than to compensate

However, the legitimate interest need not always be in securing enforcement because Lord Mance held that the test also encompassed “an interest in renegotiating the original contractual bargain in the light of the situation after or revealed by the breach”;<sup>160</sup> this interest is remedial and operates on the hypothesis that enforcement of the original obligation has failed.

The residual significance of the genuine pre-estimate of loss test is unclear. The test is obviously no longer decisive, but Lord Hodge indicated that it would remain an important yardstick for clauses “fixing the level of damages to be paid on breach”.<sup>161</sup> Similarly, Lord Neuberger and Lord Sumption held that “In the case of a straightforward damages clause, [a legitimate] interest will rarely extend beyond compensation for the breach”, such that Lord Dunedin’s four tests in *Dunlop* will remain relevant.<sup>162</sup> However, the *ParkingEye* appeal demonstrates that straightforward stipulations to pay money need not be compensatory.<sup>163</sup> *Makdessi* thus leaves unresolved how judges should distinguish an agreed damages clause (where the genuine pre-estimate of loss test remains relevant) from other stipulations to pay money (where a broader range of legitimate interests may be invoked).

*Makdessi* raises the possibility that agreed disgorgement clauses may now be enforceable. Such clauses would have been the archetype of an invalid penalty under the previous authorities; however, they now seem well-placed to pass the legitimate interest test. Although *Attorney General v Blake* required “a legitimate interest in preventing the defendant’s profit-making activity” in order to establish disgorgement damages at common law,<sup>164</sup> the validity of an agreed disgorgement clause may be wider. In particular, the penalties rule only requires a legitimate interest in deterring breach, not a legitimate interest in preventing profits being made from the breach. On the other hand, the issue whether the likely profits were proportionate to the interest in deterrence may be more difficult to answer.<sup>165</sup>

The second main issue is: whose legitimate interest counts? Given that the penalties rule applies to private disputes between contracting parties, one might have expected that the test would be confined to the legitimate interest of the party seeking to invoke the clause. However, this argument was robustly rejected in the *ParkingEye*

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the payee for the loss occasioned through the breach”, citing with approval K. Lewison, *The Interpretation of Contracts*, 5th edn (The Interpretation of Contracts, Sweet & Maxwell, 2011) [17.01].

<sup>160</sup> *Makdessi* [153].

<sup>161</sup> *Makdessi* [255]. See also [249].

<sup>162</sup> *Makdessi* [32], citing *Dunlop* (n134) 87-88 (Lord Dunedin).

<sup>163</sup> *Makdessi* [99] (Lord Neuberger and Lord Sumption): “although ParkingEye was not liable to suffer loss as a result of overstaying motorists, it had a legitimate interest in charging them which extended beyond the recovery of any loss”. See further text to n172.

<sup>164</sup> *Attorney General v Blake* [2001] 1 AC 268 (HL) 285 (Lord Nicholls).

<sup>165</sup> On the application of proportionality, see further text to n200.

appeal.<sup>166</sup> The restated test for validity can additionally take into account the interests of third parties and even society as a whole,<sup>167</sup> including where one of the contracting parties was unaware of the relevant interests.<sup>168</sup> Reliance on public interest is not entirely without precedent: in *Lordsvale*, Colman J referred to the “great disservice to international banking” if the clause was not enforced.<sup>169</sup> This type of consideration may assume greater importance following the *Makdessi* decision.

The flexibility of the legitimate interest test is demonstrated by the *ParkingEye* appeal. The case concerned a contractual licence imposing an £85 charge on any motorist who overstayed the permitted two hours' free parking in a public car park.<sup>170</sup> Although the charge fell within the jurisdiction of the penalties rule,<sup>171</sup> the Supreme Court held that it was valid for two main reasons.<sup>172</sup> First, the charge served to ensure the “efficient use of parking space in the interests of the retail outlets, and of the users of those outlets”.<sup>173</sup> Second, the charge provided “an income stream to enable ParkingEye to meet the costs of operating the scheme and make a profit from its services, without which those services would not be available”.<sup>174</sup> This reasoning sheds important light on the scope of the legitimate interest test.

The relevant interest need not be the claimant's interest. The Supreme Court reasoned that the £85 charge, which deterred motorists from staying longer than two hours,<sup>175</sup> served the interests of the retailers who owned the shops around the car park and also the public at large.<sup>176</sup> However, neither of these groups were parties to the contract.<sup>177</sup> ParkingEye, the contracting party that operated the car park, did not share the interest in enforcement. As Lord Neuberger and Lord Sumption acknowledged, “On the contrary, at least if the £85 is payable, [ParkingEye] gains by the unauthorised use,

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<sup>166</sup> *Makdessi* [99] (Lord Neuberger and Lord Sumption) and [194] and [197] (Lord Mance).

<sup>167</sup> Text to n176.

<sup>168</sup> Text to n181.

<sup>169</sup> *Lordsvale* (n72) 767, also reasoning that “It would be highly regrettable if the English courts were to refuse to give effect to such prevalent provisions while the courts of New York are prepared to enforce them”.

<sup>170</sup> The Supreme Court was persuaded that, although the initial parking was free, the contractual licence supported by consideration: [190]-[191] (Lord Mance) and [296]-[297] (Lord Toulson). The terms of the licence were displayed on signs at the entrance to and inside the car park.

<sup>171</sup> *Makdessi* [94] (Lord Neuberger and Lord Sumption), [188] (Lord Mance) and [284] (Lord Hodge).

<sup>172</sup> *Makdessi* [98]-[99] (Lord Neuberger and Lord Sumption), [193]-[199] (Lord Mance) and [286] (Lord Hodge). Lord Toulson expressly reserved judgment on the penalties issue in the *ParkingEye* appeal ([316]).

<sup>173</sup> *Makdessi* [98] (Lord Neuberger and Lord Sumption).

<sup>174</sup> *Makdessi* [98] (Lord Neuberger and Lord Sumption).

<sup>175</sup> *Makdessi* [97] (Lord Neuberger and Lord Sumption), [198] (Lord Mance) and [285] (Lord Hodge).

<sup>176</sup> *Makdessi* [98]-[99] (Lord Neuberger and Lord Sumption), [193] (Lord Mance) and [286] (Lord Hodge).

<sup>177</sup> The retailers owned but did not operate the car park. The Supreme Court held that this consideration should not make any difference to the validity of the charge: *Makdessi* [99] (Lord Neuberger and Lord Sumption) and [197] (Lord Mance).

since its revenues are wholly derived from the charges for breach of the terms".<sup>178</sup> In other words, ParkingEye's interest was in profiting from breach of the primary obligation, not in securing its enforcement.<sup>179</sup>

The contract-breaker need not be aware of the interests served by the clause. The interests invoked by the Supreme Court cannot have been apparent to individual motorists on entering the car park. Even if one regards the retail and public interest in enforcement as self-evident,<sup>180</sup> motorists could certainly not be expected to realise the importance of the charge to ParkingEye's business model. In answer to a different point, it was accepted that "the question whether a contractual provision is a penalty turns on the construction of the contract, which cannot normally turn on facts not recorded in the contract unless they are known, or could reasonably be known, to both parties".<sup>181</sup> Although this point about construction has been widely affirmed,<sup>182</sup> including in *Makdessi* itself,<sup>183</sup> it seems to contradict the legitimate interests relied upon in the *ParkingEye* appeal.

The Supreme Court took judicial notice of the fact that the parking scheme operated by ParkingEye was in the public interest. In other words, it assumed that the social costs and benefits of a scheme providing free parking funded by a minority of overstayers was overall preferable to alternative parking schemes. The Justices did not marshal any evidence in support of this (unanimous) view, nor did they justify its distributional implications. This article does not seek to evaluate that decision, besides noting the established concern that the courtroom may not be the best place to make policy choices about community welfare.<sup>184</sup> However, it would be unusual, at least within contract law, if such conclusions were allowed to trump the outcome that would be reached if balancing the interests of the contracting parties alone. For better or worse, it seems that judges must now be prepared to engage (for the first time)<sup>185</sup> directly with public interest arguments in applying the penalties rule.

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<sup>178</sup> *Makdessi* [97]. See also [124] (Lord Mance).

<sup>179</sup> Overall, the viability of the scheme depended on partial compliance, whereby a minority of overstayers effectively funded free parking for the rest. There is an obvious analogy here with overdraft charges, which the Supreme Court also upheld (on different grounds) in *Office of Fair Trading v Abbey National plc* [2009] UKSC 6, [2010] 1 AC 696.

<sup>180</sup> In practice, the interest served by vacating the space promptly after two hours is unlikely to be obvious, at least on occasions where the car park is operating at less than full capacity.

<sup>181</sup> *Makdessi* [99].

<sup>182</sup> *Commissioner of Public Works v Hills* [1906] AC 368 (PC) 376 (Lord Dunedin); *Webster v Bosanquet* [1912] AC 394 (PC) 398-399 (Lord Mersey); *Dunlop* (n134) 86-87 (Lord Dunedin); *Cooden Engineering Co v Stanford* [1953] 1 QB 86 (CA) 94 (Somervell LJ).

<sup>183</sup> *Makdessi* [9] (Lord Neuberger and Lord Sumption) and [243] (Lord Hodge).

<sup>184</sup> L Fuller, "The Forms and Limits of Adjudication" (1978) 92 Harvard Law Review 353, 394-404.

<sup>185</sup> There does not appear to be any previous history of this approach in the cases.

So, where are we now? The legitimate interest test is much broader than the previous test for validity, even under the “commercial justification” approach.<sup>186</sup> Although the restated test now refers to the “legitimate interest of the innocent party in the enforcement of the primary obligation”,<sup>187</sup> its application in the *ParkingEye* appeal reveals a more liberal approach. The clause may be valid even though the innocent party’s interest was in breach rather than enforcement,<sup>188</sup> even though the “legitimate interest” was attributable exclusively to third parties and society as a whole,<sup>189</sup> and even though the contract-breaker was probably unaware of the interests at the time of contracting.<sup>190</sup> The legitimate interest test therefore appears to function effectively as a general test of “reasonableness”.<sup>191</sup> Just as in relation to the jurisdiction stage, the restatement serves to increase the parties’ prospective certainty that their clauses will be enforced, but it leaves the test of validity itself in a less certain state.

## *ii) The boundary of punishment*

The outer boundary of validity is now said to be marked by a prohibition on punishment. Lord Neuberger and Lord Sumption held that “The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance”.<sup>192</sup> Lord Hodge similarly concluded that “The rule against penalties is a rule of contract law based on public policy ... the public policy is that the courts will not enforce a stipulation for punishment for breach of contract”.<sup>193</sup> The emphasis on punishment appears to replace two discredited dichotomies<sup>194</sup> with another dichotomy, this time “between a reasonable commercial condition on the one hand and a punishment on the other”.<sup>195</sup> The restated dichotomy is likely to raise new problems because it is doubtful whether the concept of punishment succeeds in capturing every clause that might be regarded as invalid, especially in relation to clauses imposed by commercial parties.

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<sup>186</sup> n136.

<sup>187</sup> n142.

<sup>188</sup> Text to n178.

<sup>189</sup> Text to n177.

<sup>190</sup> Text to n180.

<sup>191</sup> In the *ParkingEye* appeal, Lord Neuberger and Lord Sumption concluded that the interests served by the parking charge “appear to us to be perfectly reasonable in themselves”: *Makdessi* [98]. See also [193] (Lord Mance), concluding that the charges “were on their face reasonable”.

<sup>192</sup> *Makdessi* [32]. See also [31]: “The real question when a contractual provision is challenged as a penalty is whether it is penal”.

<sup>193</sup> *Makdessi* [243]. See also [148] (Lord Mance).

<sup>194</sup> See further text to n132 on the dichotomy between penalties and genuine pre-estimates of loss, and n138 on the dichotomy between commercial justification and deterrence.

<sup>195</sup> *Makdessi* [223] (Lord Hodge).

The facts of the *Makdessi* appeal provide the false impression that punishment offers a workable universal test for validity. In that case, the Supreme Court reasoned that the boundary of punishment had not been crossed because “the price formula in clause 5.6 had a legitimate function which had nothing to do with punishment and everything to do with achieving [the innocent party’s] commercial objective”.<sup>196</sup> Consequently, “the terms were harsh; but they were not exorbitant. They were not a punishment”.<sup>197</sup> On the facts of *Makdessi*, the dichotomy between legitimate deterrence and punishment seemed workable because the breach involved personal disloyalty by the contract-breaker, which threatened the goodwill value of the innocent party’s business; although punishment was not established on the facts, it was at least plausible in the circumstances. However, in this respect, *Makdessi* is likely to be the exception rather than the norm.

In most commercial contexts, punishment will be an implausible aim even where the relevant stipulation is (on other grounds) obviously exorbitant. For example, suppose that ParkingEye had set its parking charge at £300. The Supreme Court emphasised that it “could not charge a sum which would be out of all proportion to its interest”;<sup>198</sup> presumably £300 would cross that threshold. But could this charge be described as “punishment”? The more natural objection seems to be that this type of clause is designed to allow one party to profit from the others’ breach. However, this is precisely the kind of conduct that the Supreme Court sanctioned in *ParkingEye*.<sup>199</sup> Most “penalty” clauses inserted by commercial parties will be seeking additional profits rather than punishment. If so, the restated dichotomy may again prove unreliable in determining which stipulations are exorbitant.

In circumstances where punishment cannot provide an appropriate boundary, there are no clear criteria for assessing the proportionality of the stipulation compared with the legitimate interest of the innocent party. Lord Toulson frankly conceded that “it is impossible to lay down abstract rules ... because it depends on the particular facts and circumstances established in the individual case”.<sup>200</sup> Lord Hodge similarly concluded that “the question is ultimately a value judgment by the court”.<sup>201</sup> In determining the *ParkingEye* appeal, all of the Justices relied on parking industry standards as a factor contributing to their conclusion that the £85 charge was not exorbitant.<sup>202</sup> Industry standards may sometimes provide a useful benchmark, particularly where they have

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<sup>196</sup> *Makdessi* [82].

<sup>197</sup> *Makdessi* [282].

<sup>198</sup> *Makdessi* [100] (Lord Neuberger and Lord Sumption). See also [287] (Lord Hodge), referring to “the size of the penalty in relation to the protected interest”.

<sup>199</sup> Text to n178.

<sup>200</sup> *Makdessi* [293].

<sup>201</sup> *Makdessi* [287].

<sup>202</sup> *Makdessi* [96] and [100] (Lord Neuberger and Lord Sumption), [198] (Lord Mance) and [287] (Lord Hodge).

been set by an authoritative or democratically accountable body.<sup>203</sup> However, in other circumstances, reliance on the prevailing industry practice may allow infelicitous industries to pull themselves up by their own bootstraps.

### *iii) The weight of procedural considerations*

Although it is clear that procedural considerations can have at least some weight both for and against validity, the difficult question is how much. The survival of the penalties rule is attributable partly to the concern that current statutory protections are insufficiently comprehensive to guard against the risk of procedural unfairness.<sup>204</sup> In particular, the Supreme Court expressed a clear concern about the risk of inequality of bargaining power between small and large businesses.<sup>205</sup> These procedural concerns, regarding the process by which the bargain was reached (rather than the substance of the bargain itself), may be raised at the validity stage through the concept of unconscionability.<sup>206</sup> Lord Mance robustly rejected the submission that the unconscionability element of the validity test should be limited to egregious procedural misconduct such as duress, undue influence or misrepresentation.<sup>207</sup> Instead, at least some of the judges thought that unconscionability could encompass broader considerations of procedural unfairness.<sup>208</sup>

Procedural considerations may play an affirmative role in upholding the validity of an impugned clause. In particular, “In 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”.<sup>209</sup> This follows the approach taken in *Philips v Attorney General of Hong Kong*, where Lord Woolf held that “especially in commercial contracts”, the starting point is that “what the parties have agreed should normally be upheld”.<sup>210</sup> Even though the rule against penalties ultimately marks a derogation from freedom of contract, the jurisdiction and validity tests are both

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<sup>203</sup> In *ParkingEye*, the industry standards included the statutorily authorised practices of local authorities. However, even in these circumstances the Supreme Court emphasised that the standards were not conclusive: *Makdessi* [100] (Lord Neuberger and Lord Sumption) and [287] (Lord Hodge). See also *Murray* (n136) [70] (Arden LJ), who relied on the recommendations of the Hampel Report on Corporate Governance 1998 in determining the validity of a clause relating to a director’s severance package.

<sup>204</sup> n8.

<sup>205</sup> *Makdessi* [167] (Lord Mance) and [262] (Lord Hodge).

<sup>206</sup> *Makdessi* [152] (Lord Mance) and [287] (Lord Hodge).

<sup>207</sup> *Makdessi* [169].

<sup>208</sup> n206.

<sup>209</sup> *Makdessi* [35].

<sup>210</sup> *Philips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 B.L.R. 41 (PC) 59. See also *Robophone* (n62) 1447 (Diplock LJ) Both cases were cited with approval in *Makdessi* [33] (Lord Neuberger and Lord Sumption).

clearly conditioned by that principle.<sup>211</sup> It follows from this “strong initial presumption” that despite the rejection of a formal exception for commercial transactions,<sup>212</sup> in practice commercial parties will often be able to invoke procedural considerations in favour of validity.

The affirmative role of procedural considerations played an important role in both the *Makdessi* and *ParkingEye* appeals. In *Makdessi*, all of the Justices invoked the parties’ equal bargaining power as a reason for upholding the impugned clauses. The clauses were “part of a carefully constructed contract which had been the subject of detailed negotiations over many months between two sophisticated commercial parties, dealing with each other on an equal basis”.<sup>213</sup> In *ParkingEye*, procedural considerations were also invoked in favour of validity even though the parties were plainly not of equal bargaining power because the car park notice was a classic “take-it-or-leave-it” offer on standard terms. Instead, the court emphasised the transparency of the notice and the opportunity for motorists to use other parking facilities if they wished.<sup>214</sup>

Although it is clear that procedural considerations can be raised by both sides at the validity stage, the relative weight to be accorded to procedural and substantive considerations remains unresolved. Lord Neuberger and Lord Sumption’s sweeping proposition that “the modern rule is substantive, not procedural”<sup>215</sup> is plainly too strong, because all of the Justices invoked procedural considerations in their reasoning.<sup>216</sup> More precisely, procedural unfairness is not *necessary* to trigger invalidity,<sup>217</sup> but procedural considerations remain important. The “strong initial presumption” approach suggests that affirmative evidence of procedural fairness may weigh heavily enough to turn a substantively dubious clause into one that passes the validity test. The weight of procedural *concerns* is less clear; in other words, it remains open whether a dubious bargaining process might justify striking down a clause that would otherwise be regarded as proportionate to the innocent party’s legitimate interest.

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<sup>211</sup> See also n35.

<sup>212</sup> n9.

<sup>213</sup> *Makdessi* [82] (Lord Neuberger and Lord Sumption). See also [181] (Lord Mance) and [282] (Lord Hodge).

<sup>214</sup> *Makdessi* [100] (Lord Neuberger and Lord Sumption), [198] (Lord Mance) and [287] (Lord Hodge).

<sup>215</sup> *Makdessi* [34].

<sup>216</sup> n213.

<sup>217</sup> *Makdessi* [257] (Lord Hodge).

## IV. EFFECT

### A. Where the rule applies

One of the most significant aspects of *Makdessi* was in settling the legal effect of the penalties rule, even though this issue did not arise on the facts of either appeal. We now know that where the penalties rule applies, the clause is “wholly unenforceable”.<sup>218</sup> In other words, judges do not have the power to “scale down” an invalid clause so as to remove just the penal element. Although all of the clauses in the *Makdessi* and *ParkingEye* appeals were held to be valid, the Justices’ comments on the effect of the penalties rule represents strong obiter dicta sufficient to settle the issue for subsequent cases.<sup>219</sup> However, this clarification effectively raises the stakes at the jurisdiction and validity stages; in practice, the restated approach may well create a feedback loop that makes it even less likely that the penalties rule will be held to apply.

Previous uncertainty as to the effect of the penalties rule can be traced to the decision in *Jobson*, where the Court of Appeal held that a penalty clause could be “scaled down” to the extent of the penal element.<sup>220</sup> In that case, Nicholls LJ proposed that “In the case of a penalty clause in a contract equity relieves by cutting down the extent to which the contractual obligation is enforceable”.<sup>221</sup> The application of this approach on the facts of *Jobson* itself was exceedingly complicated; in light of present developments, it does not merit detailed review.<sup>222</sup> In summary, Nicholls LJ and Dillon LJ held that the contract-breaker could choose between two alternative options for relief,<sup>223</sup> whilst Kerr LJ (dissenting) would have offered a third.<sup>224</sup> This convoluted outcome may be explained by the fact that relief against forfeiture was unavailable for purely procedural reasons.<sup>225</sup>

More recent decisions had indicated willingness to follow the scaling-down approach.<sup>226</sup> In *Makdessi* itself, the Court of Appeal supported the *Jobson* decision in

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<sup>218</sup> *Makdessi* [9] (Lord Neuberger and Lord Sumption). See also [283] (Lord Hodge). Lord Mance expressly reserved judgment on this issue ([186]).

<sup>219</sup> Text to n231.

<sup>220</sup> *Jobson* (n26) 1037 (Dillon LJ), 1041 (Nicholls LJ) and 1049 (Kerr LJ).

<sup>221</sup> *Jobson* (n26) 1042.

<sup>222</sup> For further analysis, see *Makdessi* [84]-[87] (Lord Neuberger and Lord Sumption).

<sup>223</sup> *Jobson* (n26) 1037 (Dillon LJ) and 1045 (Nicholls LJ).

<sup>224</sup> *Jobson* (n26) 1049 (Kerr LJ).

<sup>225</sup> *Jobson* (n26) 1044-1045 (Nicholls LJ), discussed in *Makdessi* [84] and [87] (Lord Neuberger and Lord Sumption).

<sup>226</sup> *Murray* (n136) [29] (Arden LJ), holding that where a clause is penal, the “agreement is to that extent unenforceable”.

principle.<sup>227</sup> However, this position conflicted with earlier authorities. In *Financings Ltd v Baldock*, Diplock LJ held that “Whatever may have been the position before the fusion of law and equity, the effect today ... is that the penalty clause is treated as void and the plaintiff is forced to rely upon his right to such measure of damages as he would be entitled to at common law”.<sup>228</sup> Diplock LJ persisted with this exposition in several other decisions.<sup>229</sup> Nevertheless, the potential for uncertainty was still latent in these authorities because the resulting damages award could equally be explained as partial enforcement of the penalty clause rather than as a reversion to the subsisting claim for damages at common law.

*Makdessi* brings clarity to this issue by settling decisively that an invalid penalty clause is wholly unenforceable. With the exception of Lord Mance, who expressly reserved judgment,<sup>230</sup> the Justices were agreed that *Jobson* should be overruled as to the effect of the penalties rule.<sup>231</sup> In this connection, Lord Neuberger and Lord Sumption cited with approval the proposition of Hoffmann LJ in *Else* that the penalties rule is “mechanical in effect and involves no exercise of discretion at all”.<sup>232</sup> Their reasoning, in essence, was that if partial enforcement was permitted then it would require judges to “undertake an unfamiliar role”.<sup>233</sup> The courts have no power to rewrite the parties’ bargain by substituting into the contract a scaled-down version of the invalid penalty clause.<sup>234</sup>

Where a penalty clause provides for the payment of an exorbitant sum of money, its unenforceability is unlikely to raise significant problems because the innocent party will still be able to recover any losses caused by the breach through its subsisting claim for damages at common law. However, unenforceability may have more complex implications in relation to “non-classic” clauses,<sup>235</sup> because where the clause does not provide for the payment of money and is not compensatory, “There is no fall-back position at common law, as there is in the case of a damages clause”.<sup>236</sup> The consequences of unenforceability for the innocent party may then be quite drastic because the court will have not have any power to order a compromise position. In

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<sup>227</sup> *Makdessi v Cavendish Square Holdings BV* [2013] EWCA Civ 1540 [126]. However, on the facts Christopher Clarke LJ concluded ([127]) that it would be inappropriate to enforce a scaled down version of Clause 5.1.

<sup>228</sup> *Financings Ltd v Baldock* [1963] 2 QB 104 (CA) 120.

<sup>229</sup> *Robophone* (n62) 1446; *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana (The Scaptrade)* [1983] 2 AC 694 (HL) 702.

<sup>230</sup> *Makdessi* [186].

<sup>231</sup> *Makdessi* [87] (Lord Neuberger and Lord Sumption) and [230] and [283] (Lord Hodge).

<sup>232</sup> *Makdessi* [9], citing *Else* (n23) 144 (Hoffmann LJ).

<sup>233</sup> *Makdessi* [86], citing *AMEV-UDC Finance Ltd v Austin* [1986] HCA 63, (1986) 162 CLR 170, 192-193 (Mason J and Wilson J).

<sup>234</sup> *Makdessi* [87].

<sup>235</sup> See eg text to n28.

<sup>236</sup> *Makdessi* [83].

practice, this effect of the penalties rule may make judges all the more reluctant to apply the rule in the first place.

The feedback loop between effect and application created by the restated approach is illustrated by the *Makdessi* appeal. The Supreme Court upheld the validity of a clause that granted the innocent party an option to purchase shares from the contract-breaker following breach.<sup>237</sup> In holding that the clause was outside the jurisdiction of the penalties rule, Lord Neuberger and Lord Sumption reasoned that the option to purchase the shares must be characterised as “among the parties’ primary obligations” because the application of the penalties rule would involve “making a new contract for the parties”; in particular, it would enable the contract-breaker to retain an interest in a company to which he had been disloyal, contrary to the commercial purpose of the agreement.<sup>238</sup> The fact that the clause would be wholly unenforceable if the penalties rule applied therefore contributed to the conclusion that the clause must be outside the jurisdiction of the rule.

## B. Where the rule does not apply

Where the penalties rule does not apply, the court may sometimes have a limited power to achieve a compromise position by applying the equitable doctrine of relief against forfeiture. We now know that the penalties rule and relief against forfeiture can be applied sequentially; judges need not choose between a “penalty clause” or a “forfeiture clause”.<sup>239</sup> Where applicable, relief against forfeiture effectively gives the contract-breaker a second chance to perform. However, the scope of this compromise position is limited in two important respects. First, it will only assist the contract-breaker in relation to retention clauses; no compromise position is available where the clause requires the contract-breaker to pay money or to transfer property. Second, relief against forfeiture is only available for the forfeiture of proprietary or possessory rights; *Makdessi* leaves this limitation on the rule untouched.<sup>240</sup>

Where the application of the penalties rule is denied at the jurisdiction stage on the basis that the clause imposes a conditional primary obligation rather than a secondary

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<sup>237</sup> Lord Mance and Lord Hodge (with whom Lord Toulson and Lord Clarke agreed), held that Clause 5.6 was within the jurisdiction of the penalties rule but was nevertheless valid: [183], [290], [291] and [293]. Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) held that the clause was outside the jurisdiction of the penalties rule ([83]).

<sup>238</sup> *Makdessi* [83].

<sup>239</sup> *Makdessi* [160] (Lord Mance), [227] (Lord Hodge) and [294] (Lord Toulson). Lord Clarke agreed with Lord Mance and Lord Hodge. Lord Neuberger and Lord Sumption also held ([18]) that “We see the force of the arguments to that effect”, although they preferred not to decide the issue because it was not raised by either appeal.

<sup>240</sup> *Makdessi* [69] (Lord Neuberger and Lord Sumption). See also *The Scaptrade* (n229) 702 (Lord Diplock); *UK Housing Alliance (North West) Ltd v Francis* [2010] EWCA Civ 117, [2010] 3 All ER 519 [10]-[15] (Longmore LJ); *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd* [2013] UKPC 2, [2015] 2 WLR 875 [94].

obligation, the contract-breaker may be liable to pay damages *in addition* to having the clause enforced against it. Conditional primary obligations are regarded as part of the original agreement rather than as an agreed remedy that displaces the common law response to breach;<sup>241</sup> it follows from this that “damages are in principle recoverable in addition”.<sup>242</sup> In practice, enforcement of the clause may be held to have wiped out the innocent party’s loss. However, in *Makdessi*, Lord Neuberger and Lord Sumption left this issue of abatement unresolved, holding that “It is an open question whether the right to a price reduction would go to abate any loss recoverable by [the innocent party] if they had suffered any”.<sup>243</sup>

It also follows from the conditional primary obligation analysis that other remedial mechanisms could be upheld alongside the impugned clause. At first instance in *Makdessi*, Burton J upheld the clauses, but imposed a condition on their enforcement that the innocent party should repay a sum that it had already received under a Part 36 offer of compensation for the breach.<sup>244</sup> Whether or not this approach was correct depends on the stage at which the impugned clauses were upheld. If they were properly upheld at the jurisdiction stage, on the basis that they constituted conditional primary obligations, then the condition was misplaced; by contrast, if the clauses were upheld only at the validity stage, after holding that the clauses created secondary obligations, then the condition was correctly imposed. Unfortunately, this point was not debated in detail because the Court of Appeal overturned the condition and the issue was not pursued in the Supreme Court.<sup>245</sup>

## V. CONCLUSION

The penalties rule has not been abolished, but its scope has been narrowed at both the jurisdiction and validity stages. This article offers no comment on the merits of that development; academic evaluations of this “blatant interference with freedom of contract”<sup>246</sup> already abound. However, even if the rule is now regarded only as a backstop for the most egregious clauses,<sup>247</sup> it is important ask what scope remains for litigation in this field. The aim of this article has thus been to highlight several

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<sup>241</sup> See further text to n71.

<sup>242</sup> *Makdessi* [76] (Lord Neuberger and Lord Sumption).

<sup>243</sup> *Makdessi* [76].

<sup>244</sup> *Cavendish Square Holdings BV v Makdessi* [2012] EWHC 3582 (Comm), [2013] 1 All ER (Comm) 787 [63].

<sup>245</sup> *Makdessi* [120] (Lord Mance). If the issue had been live in the Supreme Court, then it may have encouraged the Justices to reach a clearer conclusion on the application of the jurisdiction test to Clauses 5.1 and 5.6: see further text to n99 and n100.

<sup>246</sup> *Makdessi v Cavendish Square Holdings BV* [2013] EWCA Civ 1540 [44] (Christopher Clarke LJ).

<sup>247</sup> See eg *Makdessi* [266] (Lord Hodge): “The criterion of exorbitance or unconscionableness should prevent the enforcement of only egregious contractual provisions”. See also [33] (Lord Neuberger and Lord Sumption).

unresolved issues that are likely to arise in the relatively few instances where a plausible case for applying the rule can still be made. The central argument has been that although the restated approach serves to increase parties' certainty that their clauses will be enforced, the new legal tests are less clear and workable than the ones that they replaced.

Of the unresolved issues, some tend towards a further narrowing of the rule. The flexibility of the distinction between conditional primary obligations and secondary obligations leaves open the opportunity to exclude several types of clause whose status presently remains uncertain. Likewise, the flexibility of the legitimate interest test leaves open that it could mean almost anything at all, given that the boundary of punishment will very rarely be reached. On the other hand, other unresolved issues may offer the opportunity to re-expand the rule. If the substance over form test is applied more intrusively than the ordinary process of construction demands, then in appropriate cases jurisdiction could still be cast quite widely. Likewise, the door remains open to rely on procedural concerns at the validity stage so as to regulate clauses that are the product of unfair bargaining processes.

The process of narrowing without abolishing the rule against penalties has created several new problems that may not be apparent from a cursory reading of the new leading authority or from early academic analyses of that decision. It may be some time before these unresolved issues can be hammered out on the anvil of concrete cases, because the general direction of travel indicated by the Supreme Court in *Makdessi* will be sufficient to warn most contracting parties not to invoke the restated rule lightly. Nevertheless, an awareness of these issues will remain of some importance to those faced with drafting clauses or advising contract-breakers on their chances of success.