Penalties

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'A damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach. This must depend on whether the innocent party has a legitimate interest in performance extending beyond the prospect of pecuniary compensation flowing directly from the breach in question.'[1]

While I had no hesitation in accepting an invitation to participate in this conference to mark the retirement of Lord Sumption from the Supreme Court, I admit to some reservation about revisiting the rule against penalties. This is an area about which a great deal has been written, especially of late,[2] and it is difficult to find something fresh or original to say (though it is never easy). It is also the case that, on the previous occasions when I have commented on the rule in writing, I have advocated its abolition.[3] Since that submission was rejected by Lord Sumption and all six of his colleagues in the Supreme Court in *Cavendish Square Holding v El Makdessi* (hereafter *Makdessi*), where I was (a small) part of the counsel team making it, anything further I might have to say in this respect risks sounding like sour grapes. That risk is therefore avoided (in this paper[4]) by accepting that the rule is here to stay and instead attempting to identify what might be thought to offer the best rationalisation of it. The principal focus is on the *test* for whether a term is a penalty, but very brief consideration is also given to the *scope* of the rule, ie when it should be applied. Some of what was said in *Makdessi* and in the conjoined appeal in *ParkingEye Ltd v Beavis* (hereafter *ParkingEye*) will come under close examination, focussing in particular on the joint speech of Lord Neuberger and Lord Sumption,[5] given the occasion of this conference.

The central argument of this paper is that while contracting parties are afforded a 'generous margin' when they agree the remedy to which they are entitled to deal with the consequences of breach, the test for a penalty is any agreed remedy which goes 'beyond' what could conceivably have been awarded by the courts. As Andrew Burrows has commented: '(t)he further the clause strays from what the courts would themselves award, the more likely it is that the agreed remedy will be regarded as penal.'[6] This is not therefore a new,[7] or entirely radical, idea, but an attempt is made in this paper to demonstrate that

* I am grateful to the conference participants for comments on an earlier draft of this paper and for the further comments of Adam Kramer, Adrian Briggs and Carmine Conte. The customary assumption of responsibility on my part applies.

[1] *Cavendish Square Holding v El Makdessi* [2015] UKSC 67; [2016] AC 1172 at [28] (Lord Neuberger & Lord Sumption).
[2] See eg. S Rowan, 'For the Recognition of Remedial Terms Agreed Inter Partes' 126 *LQR* 448; S Worthington, 'Common Law Values: the Role of Party Autonomy in Private Law' in A Robertson and M Tilbury (eds) *The Common Law of Obligations: Divergence and Unity* (Oxford, Hart Publishing, 2016); J Fisher, 'Rearticulating the Rule Against Penalties' [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' 132 *LQR* 382; A Summers, 'Unresolved Issues in the Law on Penalties' [2017] *LMCLQ* 95.
[3] E Peel, 'The Rule Against Penalties'129 *LQR* 152; E Peel, 'Unjustified Penalties or an Unjustified Rule Against Penalties' 130 *LQR* 365.
[4] I do not resile from the view that, in some respects at least, the rule is an anomaly; a view which, I think, is shared by Lord Sumption. At least that is my interpretation of his comment that it is 'a haphazardly constructed edifice which has not weathered well': [2015] UKSC 67; [2016] AC 1172 at [3].
[5] I trust that Lord Neuberger will not be offended if I refer hereafter just to Lord Sumption when citing from their joint speech.
[6] A Burrows, *Remedies for Torts, Breach of Contract and Equitable Wrongs*, 4th edn (Oxford, Oxford University Press, 2019) 392.
[7] See also W Day, 'Disproportionate Penalties in Commercial Contracts', in P Davies and M Raczynska (eds), *The Contents of Commercial Contracts* (Oxford, Hart Publishing, 2020); R Stevens, 'Rights Restricting Remedies' in A Robertson and M Tilbury (eds), *Divergences in Private Law* (Oxford, Hart Publishing, 2016) 175-176.

it offers the best interpretation of what emerges from *Makdessi*, as well as the best 'fit' with the decided cases, and that it is consistent with the concept of 'legitimate interest' when used to determine the availability of judicial remedies.[8] It does however lead one to question some of the reasoning for the decisions reached in both *Makdessi* and *ParkingEye* and the proposition in the opening dictum referred to above, that a clause may be justified even where it goes 'beyond the prospect of pecuniary compensation'.

TEST

In *Makdessi* Lord Sumption formulated the test for determining whether a contractual provision is a penalty in the following terms:[9]

> '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. 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. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity. But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations.'

For present purposes, a 'secondary obligation' is a provision which is triggered by, and intended to deal with the consequences of, a prior breach of contract, ie it provides 'a contractual alternative to damages at law'.[10] This jurisdictional requirement will be considered briefly later. It is often the case that only the first sentence of the passage above is cited, but it is important to set it out in full in order to begin with a number of propositions which form the basis of this paper.[11]

There has been considerable focus on what is meant by the reference to 'legitimate interest'. It takes its meaning from the two sentences which immediately follow. The injured party has no legitimate interest (or 'proper interest') in punishing the defaulting party, but this of course simply begs the question of when a provision, if enforced, would amount to punishment. The answer is provided by the third sentence: no punishment is involved if the remedy agreed is not out of all proportion to the injured party's interest 'in *performance* or in some appropriate alternative *to performance*'. In other words, 'legitimate interest' and what may be referred to as 'performance interest' are one and the same thing. If one pauses there, one might make the following propositions. The law recognises that a contracting party has an interest in performance or some appropriate alternative to performance. In the absence of any agreed remedy, the appropriate alternative is the remedy which the courts provide for any failure to perform which amounts to a breach, and the normal remedy is 'compensation', most commonly in the form of damages. The parties are free to agree their own remedy and the courts will enforce it provided it is not out of all proportion to the remedy, or 'compensation', which would otherwise be recoverable, this being the limit of the injured party's legitimate (performance) interest. The fact that there has to be some sufficient correlation between the agreed remedy and the remedy that would

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[8] *cf* Rowan. '"The Legitimate Interest in Performance" in the Law on Penalties' [2019] *CLJ* 148 who explores in greater detail the role of 'legitimate interest' in other areas of the law of remedies and how that might inform our understanding of the rule against penalties after *Makdessi*.

[9] [2015] UKSC 67; [2016] AC 1172 at [32].

[10] [2015] UKSC 67; [2016] AC 1172 at [14].

[11] Given the confines of this paper, I make no reference to the tests of 'extravagance' or 'unconscionability' which appear elsewhere in the speech of Lord Sumption and in the speech of the other Supreme Court Justices, nor to the relevance of 'deterrence'; other than to say that extravagance or unconscionability is reached when the parties have agreed a remedy out of all proportion to the performance interest, and the Supreme Court was entirely correct to rule that an enquiry into whether a provision acts as a deterrent is not a useful guide to whether or not it is a penalty: [2015] UKSC 67; [2016] AC 1172 at [31].

otherwise be available explains the jurisdictional requirement that the parties' agreement must amount to a 'secondary obligation'.

What the test of proportionality allows for is what has been referred to as a 'generous margin' in the parties' agreement on the appropriate level of compensation,[12] but not a departure from the underlying compensatory aim. It is at the point when the parties have agreed a remedy which cannot conceivably be regarded as 'compensation' that it amounts to unenforceable punishment. However, Lord Sumption also refers to the injured party having an interest which goes '*beyond* compensation'. Unless one is meant to countenance a departure from orthodoxy, this might look like a *non-sequitur*: the rule against penalties applies to terms which respond to breach; the injured party's legitimate interest upon breach is in some appropriate alternative to performance; the appropriate alternative is some form of compensation, being the remedial equivalent of performance; but the injured party can agree a remedy which goes 'beyond compensation' and still claim to be protecting a legitimate interest? One possible response is to say that this is just a question of terminology and what is really meant by Lord Sumption's reference to 'beyond compensation' is that the injured party may have an interest in performance which is not easily or readily measured as *pecuniary* compensation.[13] If this is correct, and it has to be for the thesis in this paper to prevail, that leaves intact the submission that an agreed remedy which goes 'beyond' what could conceivably have been awarded by the courts as a compensatory award intended to protect the performance interest of the injured party is a penalty.

The questions raised by this interpretation of Lord Sumption's test for a penalty are whether there is a real and workable distinction between an agreement which amounts to a 'generous margin' in determining compensation for loss of the performance interest and an agreement which goes 'beyond' this; and whether this distinction alone should be the key to whether an agreed remedy is an unenforceable penalty. These questions are addressed primarily by analysing the decisions in some of the leading cases on penalties, but it is helpful to begin by first considering the role of 'legitimate interest' in relation to judicial remedies.

'Legitimate interest' and judicial remedies

The concept of a 'legitimate interest' of the injured party, or something like it (if not by name), has been resorted to in regulating the availability and scope of judicial remedies. It is used to justify awarding to the injured party a particular remedy on the basis that it is, in the circumstances, the appropriate compensatory award ('an appropriate alternative to performance').

Action for the price

Perhaps the leading example of a judicial remedy, the availability of which is determined by whether the injured party had a 'legitimate interest' in its award, is the action for the price. In *White & Carter* (*Councils*) *Ltd v McGregor*[14] C agreed to advertise D's business for three years on plates attached to litterbins. D repudiated the contract on the day it was made, but instead of accepting D's repudiation and suing for damages, C prepared the plates and displayed them, and claimed the price due under the contract. This action is only available if C is able to complete performance so that the price is due, but

[12] See n 42 below.
[13] See the dictum at n 24 below.
[14] [1962] AC 413.

in the *White & Carter* case Lord Reid suggested a further restriction in a passage which is often cited in truncated form, but which merits being set out in full:[15]

> 'It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself. If a party has no interest to enforce a stipulation, he cannot in general enforce it: so it might be said that, if a party has no interest to insist on a particular remedy, he ought not to be allowed to insist on it. And, just as a party is not allowed to enforce a penalty, so he ought not to be allowed to penalise the other party by taking one course when another is equally advantageous to him.'

This passage and, in particular, Lord Reid's reference to 'legitimate interest' has been criticised for being uncharacteristically vague,[16] but this does, to some extent, seem to overlook the illustration which immediately followed:[17]

> 'If I may revert to the example which I gave of a company engaging an expert to prepare an elaborate report and then repudiating before anything was done, it might be that the company could show that the expert had no substantial or legitimate interest in carrying out the work rather than accepting damages: I would think that the de minimis principle would apply in determining whether his interest was substantial, and that he might have a legitimate interest other than an immediate financial interest. But if the expert had no such interest then that might be regarded as a proper case for the exercise of the general equitable jurisdiction of the court.'

What appears to be acknowledged is that, if the injured party has a 'legitimate interest' in performance, some margin is allowed in determining the most appropriate remedy to give effect to it. Thus, in the example given, had the expert sued for damages, his interest 'other than an *immediate* financial interest' might, even at the time, have extended to financial loss consequent upon loss of reputation,[18] but such loss would not be easy to prove with any certainty; hence justifying the action for the price. But if it is clear that the expert had no interest at all of the sort which might merit a compensatory award, the action would not be available (in the same way, as Lord Reid observes, that any agreement to pay a sum due on breach, rather than the price, would be a penalty).

In *White & Carter* itself the action for the price also provided some margin in relation to mitigation in that, by claiming the price, rather than accepting the repudiation and claiming damages, C avoided the duty to mitigate. But as Lord Reid pointed out,[19] there was 'nothing in the findings of fact' to support a case that C had unjustifiably passed up a straightforward opportunity to mitigate and, where this is the case, the action is not available.[20] That the injured party is only afforded some margin as far as the mitigation rules are concerned, and cannot evade them altogether, is captured in Cooke J.'s observation that the effect of the authorities since *White & Carter* is that 'an innocent party will have no legitimate interest in maintaining the contract if damages are an adequate remedy and his insistence on maintaining the contract can be described as "wholly unreasonable", "extremely unreasonable" or, perhaps, in my words, "perverse"'.[21] To allow behaviour of this sort would result in a remedy going beyond C's 'legitimate interest'.

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[15] [1962] AC 413 at 431.
[16] J Carter, '*White and Carter v McGregor* – How Unreasonable' 128 *LQR* 490, 491.
[17] [1962] AC 413 at 431.
[18] See, eg *Cointat v Myham & Son* [1913] 2 KB 220.
[19] [1962] AC 413 at 431.
[20] See, eg *The Puerto Buitrago* [1976] 1 Lloyd's Rep 250; *The Alaskan Trader* [1983] 2 Lloyd's Rep 645
[21] *The Aquafaith* [2012] EWHC 1077 (Comm); [2012] 2 Lloyd's Rep 61 at [44].

Specific Performance

In *Attorney General v Blake*, Lord Nicholls described the award of specific performance in *Beswick v Beswick*[22] as being based on the recognition that 'the innocent party to the breach of contract had a legitimate interest in having the contract performed even though he himself would suffer no financial loss from its breach'.[23] And, in *Makdessi*, Lord Sumption referred to the remedy in the following terms:[24]

> '… specific performance of contractual obligations should ordinarily be refused where damages would be an adequate remedy. This is because the minimum condition for an order of specific performance is that the innocent party should have a legitimate interest extending beyond pecuniary compensation for the breach. The paradigm case is the purchase of land or certain chattels such as ships, which the law recognises as unique.'

Here we see the concept of an interest extending 'beyond *pecuniary* compensation',[25] but when it is awarded, specific performance is not a remedy which goes beyond a compensatory award. Rather, it is the only form of remedy which assures that there is adequate compensation, eg no amount of money can enable the replacement of something which is regarded as 'unique', and to have awarded only nominal damages in *Beswick* would have defeated the purpose of the contract which was to provide an annuity to the deceased claimant's widow.

Account of profits

In *Attorney-Gen v Blake* itself the House of Lords acknowledged that an account of profits may exceptionally be available as a remedy for breach of contract and Lord Nicholls suggested as a 'useful general guide…whether the plaintiff had a legitimate interest in preventing the defendant's profit-making activity and, hence, in depriving him of his profit.'[26] In *Morris-Garner v One Step (Support) Ltd* (hereafter *One Step*) Lord Sumption suggested that *Blake* should be seen as another case where the claimant's interest in performance 'extended beyond pecuniary loss',[27] on which basis the remedy of an account is awarded when necessary to give effect to the performance interest.[28] It is not available where it would amount to a remedy going *beyond* the performance interest. For example, if D, in breach of a contract for the sale of goods where there is an available market, fails to deliver the goods to C, C is entitled to no more than the difference between the contract price and the market price.[29] This fully protects his performance interest and he has no claim to any profit which D may have made by selling the goods to a third party after paying damages, if any, to C.

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[22] [1968] AC 58.
[23] [2001] 1 AC 268 at 282.
[24] [2015] UKSC 67; [2016] AC 1172 at [30].
[25] See above, text to n 13.
[26] [2001] 1 AC 268 at 285.
[27] [2018] UKSC 20; [2019] AC 649 at [111].
[28] The recognition of a non-pecuniary interest in the government is one thing, but it is nonetheless difficult to describe an account as a compensatory award given that the award is dictated by what the defendant has gained. A further reason why it should only be available in exceptional circumstances?
[29] Sale of Goods Act 1979, s.51(3).

Negotiating damages

In the three examples just considered, the recognition of the injured party's 'legitimate interest' justified the award of a remedy other than damages: the price, specific performance, or an account of profits. In this final example, it has led the courts to award damages on an unconventional basis.[30] In *One Step* the Supreme Court acknowledged that damages representing the sum which might hypothetically and reasonably have been negotiated by the parties to release the defendant from the contractual obligation which has been breached may be awarded in two circumstances: first, 'where the breach of contract results in the loss of a valuable asset created or protected by the right which was infringed'[31] and that right has an 'economic value…even in the absence of any pecuniary losses';[32] secondly, where it is clear that the claimant will have suffered pecuniary loss, but a hypothetical negotiation is the only, or most reliable, method of assessing that loss. In the former, damages are awarded for loss which is not 'of a conventional kind';[33] in the latter, damages are awarded for conventional loss, but assessed in an unconventional way. This is not the place to examine in detail the concept of 'asset-creating' or 'asset-protecting' contractual rights;[34] rather the point to be made is that, in both circumstances, the court recognises the interest of the claimant in performance and attempts to put a value on that performance interest: 'the imaginary negotiation is merely a tool for arriving at that value'.[35] In the *One Step* case itself, where the defendant breached restrictive covenants entered into on the sale of her interest in a business, it was held that the claimant had not been deprived of a valuable 'asset', but it was, in Lord Sumption's words, 'inconceivable' that it had not suffered pecuniary loss and the case was remitted to the trial judge with a direction that evidence of a hypothetical release fee might be resorted to as an 'evidential technique for estimating the claimant's loss'.[36]

The test of proportionality: 'a generous margin'

From the brief survey of judicial remedies just carried out, it is possible to conclude that a guiding principle for the courts, sometimes captured by reference to a 'legitimate interest', is the need to ensure a remedy which best protects, but does not go beyond, the 'performance interest' of the injured party. This is, or should be, the same principle which determines whether an *agreed* remedy of the parties is enforceable: the parties are permitted to contract out of the uncertainty which may exist in relying on the judicial remedies otherwise available, but not go beyond what the courts would regard as the limit of their performance interest. A few leading examples are considered, before concluding with an assessment of the decisions in *Makdessi* and *ParkingEye*.

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[30] In *One Step*, the utility of any reference to the 'legitimate interest' of the injured party was, if anything, deprecated: [2018] UKSC 20; [2019] AC 649 at [90] (Lord Reed), but, as submitted above, on closer examination it is just another way of referring to the injured party's performance interest.

[31] [2018] UKSC 20; [2019] AC 649 at [92] (Lord Reed).

[32] [2018] UKSC 20; [2019] AC 649 at [93] (Lord Reed).

[33] [2018] UKSC 20; [2019] AC 649 at [30] (Lord Reed).

[34] See Adam Kramer's paper, at xx. In *Priyanka Shipping Ltd v Glory Bulk Carriers Pte Ltd* [2019] EWHC 2804 (Comm), C sold a vessel to D on condition that it was to be scrapped, but D traded the vessel before C obtained an injunction to enforce the obligation to scrap. C's contractual right of control *over D's property* (ie the vessel, after the sale) was analogous to other cases where C has been awarded 'negotiating damages' (eg *Wrotham Park Estate Co Ltd v Parkside Homes Ltd* [1974] 1 WLR 798 (restrictive covenant over D's land); *Experience Hendrix LLC v PPX Enterprises Inc* [2003] EWCA Civ 323; [2003] 1 All ER (Comm) 830 (restriction over the commercial exploitation of D's intellectual property)). The decision not to award negotiating damages in relation to the trading done before the injunction is therefore open to doubt, but *quaere* the validity of any agreement the parties might have made in advance about the sums to be paid by D to C;*cf Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79, below.

[35] [2018] UKSC 20; [2019] AC 649 at [91] (Lord Reed).

[36] [2018] UKSC 20; [2019] AC 649 at [106] (Lord Sumption); *cf* at [100] (Lord Reed).

Actual loss and legally recoverable loss

For the purpose of the rationalisation of the test for a penalty advocated in this paper, it is necessary to draw a preliminary distinction between what has been referred to as 'actual loss' and 'legally recoverable loss'.[37] 'Actual loss' refers to all loss in fact caused by the defaulting party's breach of contract but, as is well established, the level of damages which may be legally recovered is not simply a matter of 'but for' causation.[38] Even in relation to that requirement, it is necessary for the injured party to prove the loss, or level of loss, in fact suffered, so that notwithstanding the willingness of the courts to indulge in a degree of speculation,[39] damages may not be recovered for lack of certainty of proof. Such proven actual loss may nonetheless still not be awarded as damages because of other limitations on recovery, such as mitigation and remoteness, eg where C incurs a loss on a further contract as a consequence of D's breach, but such loss is too remote to be recovered as damages because D was unaware of the risk of this type of loss at the time of her contract with C. The significance of this distinction is that recovery of C's actual loss, where this is agreed by the parties, may still be regarded as a compensatory award. Thus, in the example just given, if C and D had agreed that, in the event of a breach by D, she should pay a sum which represented (or was intended to represent) C's loss on the further contract, the agreed remedy is still a compensatory award based on C's actual loss, notwithstanding that the full extent of the loss might not otherwise have been recoverable as damages because of remoteness.[40] The question which follows is to what extent can the parties contract out of the potential limitations on recoverable damages which is what, in effect, C and D would have done, before their agreement amounts to a penalty? In the examples which follow, it will be seen that the parties are afforded a degree of 'margin' in contracting out of the strict requirements of mitigation, remoteness and proof of loss in order to ensure recovery of what may have been their actual loss. In all of them, it is a question of the limits of contracting out of uncertainty.

Mitigation uncertainty

So far as mitigation is concerned, one might point to the decision of the Court of Appeal in *Murray v Leisureplay Plc*[41] in which no penalty was found to have been created by a clause which entitled a director to the payment of 12 months' gross salary and pension contributions for unlawful termination of his service contract. This is the case in which Arden LJ observed that a contractual provision is not a penalty simply because it may result in 'overpayment', ie a sum greater than the legally recoverable damages, because '(t)he parties are allowed a generous margin'.[42] Though not an observation made by Arden LJ, such margin is also justified on the basis that the parties have to legislate for the consequences of breach at the time of the contract. The judge had found that the clause was a penalty because it failed to take any account of the requirement of mitigation which would have applied to an assessment of damages. Buxton LJ did not regard this as decisive on the basis that it would have been difficult to say with confidence at the time of entering into the contract what might happen to the director, were he to be dismissed, and 'such a clause would directly invite disputes about the reasonableness of [the director's] behaviour after termination, of the kind that clauses stipulating the amount of compensation

[37] See A Burrows, *Remedies for Torts, Breach of Contract and Equitable Wrongs*, 4th edn (Oxford, Oxford University Press, 2019) 392.
[38] See Adam Kramer's paper at xx.
[39] *Simpson v The London and North Western Railway Co* (1876) 1 QBD 274 at 277 (Cockburn CJ); *Watson, Laidlaw & Co Ltd v Pott, Cassels & Williamson* 1914 SC (HL) 18 at 29-30 ('sound imagination and the practice of the broad axe').
[40] See the discussion of the *Robophone* case below.
[41] [2005] EWCA Civ 963; [2005] IRLR 946.
[42] [2005] EWCA Civ 963; [2005] IRLR 946 at [43].

are precisely designed to avoid.'[43] In sum, while operating within the confines of what may still be described as the director's performance interest (ie what he may actually have lost), the parties were allowed some margin to contract around the *uncertainty* associated with mitigation.

This might be contrasted with the sort of case where any question of mitigation would be clear and straightforward even at the time of the contract. For example, in a contract for the sale of goods where there is an available market, the normal measure of damages for breach by either the seller or the buyer is the difference between the contract price and the market price.[44] This simply reflects the fact that, upon breach, either party is expected to mitigate by selling the goods, or buying a substitute, at the market price. This is the limit of the parties' performance interest. If the parties to such a contract agreed in advance a liquidated sum to deal with breach, it seems very likely, in contrast to *Murray v Leisureplay*, that it would be regarded as a penalty to the extent that it failed to take account of the requirement of mitigation.[45]

Remoteness uncertainty

A similar point can be made in relation to remoteness, the effect of which, in determining whether a clause amounts to a penalty, is dealt with by Diplock LJ in *Robophone Facilities Ltd v Blank*.[46] A key passage in his analysis is as follows:[47]

> 'If the contract contained an express undertaking by the defendant to be responsible for all *actual loss* to the plaintiff occasioned by the defendant's breach, whatever that loss might turn out to be, it would not affect the defendant's liability for the loss actually sustained by the plaintiff that the defendant did not know of the special circumstances which were likely to cause any enhancement of the plaintiff's loss. And so if at the time of the contract the plaintiff informs the defendant that his loss in the event of a particular breach is likely to be £X by describing this sum as liquidated damages in the terms of his offer to contract, and the defendant expressly undertakes to pay £X to the plaintiff in the event of such breach, the clause which contains the stipulation is not a "penalty clause" unless £X is not a genuine and reasonable estimate by the plaintiff of the loss which he will in fact be likely to obtain.'

What appears to be said is that a reasonable estimate of the 'actual loss' occasioned by the breach represents the limit of what may be recoverable by the injured party, but such sum is recoverable notwithstanding the fact that, *in the absence of the agreed sum*, the full extent of the claimant's actual loss might not be recoverable on grounds of remoteness.[48]

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[43] [2005] EWCA Civ 963; [2005] IRLR 946 at [115].

[44] Sale of Goods Act 1979, ss.50(3), 51(3).

[45] One imagines that such a provision would be very unusual, if it is used at all; more likely is a provision which attempts, by agreement, to 'crystallise' the damages recoverable as the difference between the contract price and the market price: see, for example, Clause 20 of GAFTA 49: *Bunge SA v Nidera BV* [2015] UKSC 43; [2015] 2 Lloyd's Rep 469, discussed in Adam Kramer's paper. The decision in that case was that Clause 20 did not, as a matter of construction, exclude any consideration of the effect of post-breach events on the claim for damages. As a result, the defendant sellers, who were guilty of an anticipatory breach, were able to defeat the claim by relying on the fact that post-breach events showed that they would have had a lawful excuse for their failure to perform when performance was due (*cf The Golden Victory* [2007] UKHL 12; [2007] 2 AC 353). At the conference, Adam Kramer asked whether, if the clause had excluded this consideration, it would have amounted to a penalty. My view is that it would not, precisely because the parties should be permitted to contract out of the uncertainty inherent in the willingness of the courts to take account of post-breach events known by the time of the hearing, which is the principal criticism of the decision in *The Golden Victory* (see the dissenting judgments of Lord Bingham and Lord Walker).

[46] [1966] 1 WLR 1428.

[47] [1966] 1 WLR 1428 at 1448 (emphasis added).

[48] While Diplock LJ concludes that the injured party's actual loss would be recoverable notwithstanding that the requirements of the remoteness test have *not been met*, the way that test is rationalised by Lord Hoffmann in *The Achilleas* [2008] UKHL 48; [2009] 1 AC 61 and the Court of Appeal in *Supershield Ltd v Siemens Building Technologies FE Ltd* [2010] EWCA Civ 7; [2010] 1 Lloyd's Rep 349 (namely that remoteness is determined by whether the defendant assumed responsibility for the type of loss incurred, regardless of foresight or contemplation by the defendant) opens up an alternative analysis under which

Proof of loss uncertainty

The distinction between an agreement which amounts to a 'generous margin' in determining the remedy intended to protect the performance interest and an agreement which goes 'beyond' what could conceivably be awarded as a remedy by the courts to achieve the same aim is perhaps most difficult to draw in the type of case where uncertainty lies, not in the application of limitations like mitigation or remoteness, but in simply proving any actual loss occasioned by the breach. This may be illustrated by the analysis of four cases: *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* (hereafter *Dunlop*), *Vivienne Westwood Ltd v Conduit Street Development Ltd* (hereafter *Westwood*), *Makdessi* and *ParkingEye*.

In *Dunlop*, as is well known, a contract for the supply of tyres, covers and tubes contained a resale price maintenance clause[49] which was breached by the purchaser, and a further clause which provided for the payment of £5 for every tyre, cover or tube sold in breach of any provision of the agreement. Prior to the decision in *Makdessi*, the case was most well-known for the speech of Lord Dunedin and his formulation of four tests which 'may prove helpful' in determining whether a clause is a penalty. I gratefully adopt Lord Sumption's summary of them in *Makdessi*:[50]

> '(a) that the provision would be penal if "the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach"; (b) that the provision would be penal if the breach consisted only in the non-payment of money and it provided for the payment of a larger sum; (c) that there was "a presumption (but no more)" that it would be penal if it was payable in a number of events of varying gravity; and (d) that it would not be treated as penal by reason only of the impossibility of precisely pre-estimating the true loss.'

The decision that the provision for payment of £5 per item was not a penalty rested heavily on the last of the 'tests' set out above but, as Lord Sumption observed in *Makdessi*, it seems clear that this result was strongly influenced by Lord Atkinson's reasoning.[51] He emphasised the importance to Dunlop of the protection of their brand, reputation and goodwill, and their authorised distribution network. The provisions of the contract, including the resale price maintenance clause, were intended to 'prevent the disorganisation of their trading system and *the consequent injury* to their trade in many directions'.[52] In that context, 'they had an obvious interest to prevent…undercutting' and it was 'impossible to say that *that interest* was incommensurate with the sum agreed to be paid'.[53] In other words, while the cumulative effect of each individual breach damaged Dunlop's trading system and therefore its goodwill, the uncertainty, not to say impossibility, of attributing actual loss to each and every breach if Dunlop was confined to a claim for damages, justified the payment of a fixed sum per breach which was not out of all proportion to Dunlop's performance interest, ie what the court acknowledged Dunlop may have actually lost.

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it is because of the agreed remedy that the test of remoteness *has been met*. In this respect, the finding of a penalty by Blair J in *The Paragon* [2009] EWHC 551 (Comm); [2009] 1 Lloyd's Rep 658 at [22] is open to doubt (affirmed [2009] EWCA Civ 555; [2009] 2 Lloyd's Rep. 688 without explicit reference to this point, but see at [36]).

[49] This would now be unlawful but was a legitimate restriction of competition at the time.

[50] [2015] UKSC 67; [2016] AC 1172 at [24].

[51] [2015] UKSC 67; [2016] AC 1172 at [24].

[52] [1915] AC 79 at 91-92 (emphasis added).

[53] [1915] AC 79 at 91-92.

In the passage from Lord Sumption's speech with which this part began,[54] he referred to 'a straightforward damages clause', in relation to which Lord Dunedin's four tests would usually be 'perfectly adequate to determine its validity'. One assumes that he would regard the clause in the *Dunlop* case as meeting the description of a 'a straightforward damages clause', but Lord Dunedin's tests can only explain that decision on the basis of a broad interpretation of them, in line with the underlying reasoning of Lord Atkinson. In this respect, it is notable that in Lord Sumption's own summary of the tests, there is no mention of the concept also referred to by Lord Dunedin - that the agreed sum should be a 'genuine pre-estimate of damage' - perhaps on the basis that it is this concept which runs the risk of too readily concluding that a clause amounts to a penalty to the extent that it departs from what would be legally recoverable as damages, thus depriving the parties of any sort of margin. This can be met, of course, by emphasising that what is required is a 'genuine' pre-estimate, not a precise one,[55] of 'damage', and not of damages.

The decision in *Dunlop* may be contrasted with the decision in *Westwood*[56] in which the clause in question was found to be a penalty even after the decision in favour of a broader approach to, or understanding of, the test for a penalty in *Makdessi*. In the *Westwood* case C and D entered into a lease, accompanied by a side letter, the effect of which was to reduce the rent reserved under the lease. The parties agreed that this arrangement could be terminated by C if D breached any of the terms of the side letter, or the lease, in which case the side letter was to be treated as if it 'never existed' and C would have to pay the rent under the lease, with retrospective effect.[57] Timothy Fancourt QC, sitting as a Deputy High Court Judge, rejected a submission that the clause allowing for this was a 'primary obligation' under which D had a conditional right to a discounted rent. D's 'primary obligation' was to pay the lower rent and when it committed a breach by failing to make a rental payment on time, some six years into the lease, it came under the secondary obligation to pay the increased rent. That secondary obligation was a penalty because:[58]

> '[C] cannot argue that it had a legitimate interest as such in seeing the rent revert to what it calls the market rental level. That would be a legitimate interest in non-performance of [D's] obligations, not a legitimate interest in their performance. [C] must establish that it had a greater interest in seeing [D] perform all its obligations promptly than would be compensated by interest, damages and costs otherwise recoverable for a breach of covenant.'

In the terms in which the test for a penalty is rationalised in this paper, it is the interpretation of the last sentence in this passage which is significant. It amounts to the conclusion that there was no reason to believe that damages would not adequately protect C's performance interest in the form of any actual loss which it may have incurred; unlike *Dunlop*, this was not a case of an uncertain actual loss for which C was simply being afforded a 'generous margin' and enforcement of the clause would therefore amount to a penalty.[59]

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[54] See above, at n 9.

[55] *Murray v Leisureplay Plc* [2005] EWCA Civ 963; [2005] IRLR 946 ('the expression merely underlines the requirement that the clause should be compensatory rather than deterrent') (Buxton LJ). After *Makdessi*, it is necessary to substitute 'punitive' for 'deterrent'.

[56] [2017] EWHC 350 (Ch).

[57] The court held that it would have been possible to sever the words which led to this effect so that the reversion to the market rent would only apply prospectively. The judge would still have found that this amounted to a penalty, but acknowledged that it would not have been so clear cut.

[58] [2017] EWHC 350 (Ch) at [52].

[59] For the purpose of this paper, what matters is the perception of the judge that C's performance interest, in terms of what *it may actually have lost*, was fully protected by an award of damages. That conclusion is however open to challenge. For example, it seems to be based on an assessment carried out at *the time of the breach* which was relatively minor, whereas the test for a penalty is applied at the date of the contract. It is necessary to resort to this decision, as a contrast to *Dunlop*, simply because the finding of a penalty is very rare.

In light of the proposed rationalisation of the test for a penalty, one can now turn to the decisions in *Makdessi* and *ParkingEye*. In *Makdessi* the defendant sold a business to the claimant by way of the sale of shares representing a controlling interest, at a price which included a very significant premium for goodwill. Part of the price was guaranteed, but the balance was payable in instalments which depended on the future performance of the business. Under the share purchase agreement, if the defendant became a 'Defaulting Shareholder' he was no longer entitled to the last two instalments of the price which would otherwise be due (clause 5.1) and the claimant could exercise a call option for the purchase of the defendant's remaining shareholding at a price calculated by net asset value (clause 5.6), ie excluding any premium for goodwill. The defendant breached certain restrictive covenants in connection with his participation in other businesses and his soliciting of clients of the business sold which made him a Defaulting Shareholder. The claimant sought to enforce both clauses. The estimate of the sums on which the defendant would lose out were inevitably a matter of speculation and dispute, but it was acknowledged that it could be up to *c* $45m under clause 5.1 and up to *c* $67m under clause 5.6.

While the Supreme Court decided unanimously that neither clause was a penalty, they did not do so for the same reasons. According to Lords Neuberger, Sumption and Carnwath, the rule against penalties did not *apply* to either provision because they both amounted to primary obligations, while the rest of their Lordships concluded that they did not amount to a penalty under the applicable test, or at least they did not amount to a penalty *even on the basis that they were secondary obligations.*[60]

Lord Sumption described clause 5.1 as 'in reality a price adjustment clause'[61] and this analysis is to be preferred.[62] At the risk of over-simplification, in substance the parties had agreed to the sale and purchase of the shares on one of two bases, either with the goodwill intact, or without; the former at the full price, the latter at a reduced price. The only reason to doubt this analysis is that the event which determined upon which of the two bases the sale would be completed amounted to a breach of the restrictive covenants, but the involvement of a breach, in context, was incidental.[63] This finding avoided the obvious difficulty which the Court of Appeal faced in its decision to apply the test and find that the clause was a penalty; namely that, had compliance with the restrictive covenants not been made the subject of any obligation on the part of the defendant, but instead been drafted as a condition precedent to his entitlement to the further payments, the rule would not have been engaged because there would have been no breach involved at all.[64] Under the approach advocated by Lord Sumption, for the rule against penalties to apply, it is necessary not only for a breach to have been committed, but for the clause in question to have been intended to provide a remedial response to the breach.

What is a little curious is that one might have expected that, if the correct analysis of clause 5.1 is that it was a primary obligation, and therefore the rule against penalties *did not apply*, that should have been that and there should have been no need to discuss Cavendish's 'legitimate interest' which is part of the *test* for a penalty *if the rule applies*. To put it another way, Lord Sumption's test begins by asking '*whether* the impugned provision is a secondary obligation' and clause 5.1 was not a secondary obligation. And yet, having reached this conclusion, Lord Sumption goes on to discuss the claimant's 'legitimate interest' which he described as 'measuring the price of the business to its value' and therefore a matter 'for negotiation, not forensic assessment.'[65] It is understood that what is intended by

[60] This acknowledges what is a degree of ambiguity in the speech of Lord Mance.
[61] [2015] UKSC 67; [2016] AC 1172.
[62] Contrast Day, above, n 7. It is also the preferred analysis for 'default interest' provisions in loan agreements which *prospectively* adjust the rate payable by a borrower in default by way of a revaluation of the credit-risk for the lender: *Lordsvale Finance v Bank of Zambia* [1996] QB 752.
[63] *cf Euro London Appointments Ltd v Claessens International Ltd* [2006] EWCA Civ 385; [2006] 2 Lloyd's Rep 437.
[64] *cf Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718 (Ch) at [47]; *Imam-Sadeqe v Bluebay Asset Management (Services) Ltd* [2012] EWHC 3511 (Comm); [2013] IRLR 344 at [221].
[65] [2015] UKSC 67; [2016] AC 1172 at [75].

this is simply to reinforce that, precisely because 5.1 was a price clause, the price was solely for the parties to determine without any room for review by the courts. In this context, there is no difficulty in Lord Sumption's observation that the claimant had a 'legitimate interest…which extended beyond the recovery' of the loss which might flow from the breach of the restrictive covenants,[66] for while it is argued in this paper that recovery beyond any conceivable actual loss should be the hallmark of a penalty, this is only on the basis that the rule against penalties applies. This is the sense in which the questions of jurisdiction and validity go hand in hand. If the clause is intended to deal with the consequences of breach, it is a penalty if it goes beyond protection of the performance interest in the form of any conceivable actual loss, even after allowing a generous margin in its assessment. If it is a price clause, or a primary obligation, it only determines what the parties' performance interest is in the first place and this is for the parties alone to determine. This of course brings into sharp relief the distinction between a primary obligation and a secondary obligation for the purpose of the rule, which is considered briefly below.

If the decision in *Makdessi*, in relation to clause 5.1, can be explained on the basis it was in reality a price clause, so that the question of having agreed a *remedy* which goes beyond the performance interest simply did not arise, what is one to make of the reasoning of the other members of the Court? While Lord Hodge conceded that there was a 'strong argument' that, in substance, clause 5.1was a primary obligation,[67] he formed the view that, even if it were correct to analyse it as a 'secondary provision', it was not an unenforceable penalty. The explanation cannot lie in the fact that he adopted a different test,[68] but can such a conclusion be reached on the basis of the rationalisation of the test for a penalty advanced herein; namely that clause 5.1 did not go beyond the performance interest of the claimant in the form of any conceivable actual loss?

Lord Hodge gave six reasons for his conclusion that clause 5.1 was not a penalty, but the essence of his reasoning is much the same as that which led Lord Sumption to conclude that clause 5.1 was in reality a price clause; namely that the restrictive covenants were intended to protect the value of the company's goodwill. What was lost by *any* breach, whether minor or major, was the value of that goodwill: clause 5.1 was 'addressing the disloyalty of a seller who was prepared *in any way* to attack the company's goodwill'.[69] While this perhaps leads more obviously to the conclusion that clause 5.1 was a price clause, it is possible to regard the enforcement of clause 5.1 as affording the parties a generous margin in agreeing the remedy to protect their performance interest, without going beyond it. As Burton J observed at first instance,[70] once the restrictive covenants are breached, the 'wolf is in the fold'. What is meant by that observation is that the goodwill of the company would undoubtedly have been damaged, but by how much and to what extent, particularly in a case like *Makdessi* where the defendant himself was so closely identified with, and integral to, the business? As Lord Sumption observed: 'there are no juridical standards by which to answer that question satisfactorily.'[71] But as we have seen, it is precisely where there may be no juridical standards, or no prospect of 'forensic assessment', or where the outcome of applying such standards and assessment is uncertain, that there is room for a generous margin.

One might in this respect refer back to the *One Step* case which was also concerned with the breach of restrictive covenants designed to protect the goodwill of the business acquired from the defendant. As

[66] [2015] UKSC 67; [2016] AC 1172 at [75].
[67] [2015] UKSC 67; [2016] AC 1172 at [270].
[68] [2015] UKSC 67; [2016] AC 1172 at [293]; *cf* at [152] (Mance).
[69] [2015] UKSC 67; [2016] AC 1172 at [275].
[70] [2012] EWHC 3582 (Comm); [2013] 1 All ER 787 at [43].
[71] [2015] UKSC 67; [2016] AC 1172 at [75].

acknowledged by Lord Sumption in that case, it is notoriously difficult to value loss of goodwill: 'the economic effect of the breaches is inherently incapable of being precisely estimated, and may be incapable of even imprecise measurement',[72] but it was precisely because it was 'inconceivable' that the claimant had not suffered significant loss (ie that it had a performance interest to which it was entitled to protection) that the case was remitted on the basis that a hypothetical release fee might provide an appropriate technique for assessing the claimant's loss. In *Makdessi*, the 'release fee' was not a matter of hypothesis; it had already been agreed by the parties, so that the only issue to be decided was whether it was unreasonable. It is clear from the decision in *Makdessi* that it was not, largely because it was a matter for the parties to agree.

It is therefore possible to see how Lord Sumption and Lord Hodge may have arrived at the conclusion that clause 5.1 was not a penalty by two different routes and, indeed, one wonders how different they really are. At the risk of over-simplification,[73] the price which is paid for the goodwill of a business is usually intended to reflect the value of what may roughly be described as its 'earning power', expressed as a capital sum on the date of acquisition. In *Makdessi*, the full price *(x)* was intended to reflect the value of the goodwill *with* the defendant's continued loyalty and service; the reduced price payable in the event of withholding the last two instalments (*n*) was intended to reflect the value of the goodwill *without* the defendant's loyalty and service. Whether *n* is viewed as an attempt to capture the potential loss of earnings on the basis of payment of the full price (*x)*, or is viewed as an adjustment to the price (*x*-*n*) because the business will not generate those earnings really makes no difference. This may explain why Lord Sumption[74] and Lord Hodge[75] both made the point that, on the basis that clause 5.1 was enforceable, any additional damages would amount to double recovery.[76] It may also explain why Lord Sumption discussed clause 5.1 in terms of the claimant's 'legitimate interest', notwithstanding his decision that it was a price clause. If *n* appears to exceed the performance interest, ie payment of *x*-*n* for the business without the defendant's loyalty and service is not a proportionate or 'appropriate alternative to performance' to payment of *x* with the defendant's loyalty and service, this is an indication not only that the clause is not really a price adjustment clause, so that the rule against penalties applies, but also that it is a penalty.[77]

Clause 5.6 may be dealt with more briefly. Again, it is discussed by Lord Sumption in terms of the claimant's legitimate interest, but ultimately it is regarded as a primary obligation with an obvious commercial rationale, given the need to sever the connection between the claimant and the defendant, in light of his conduct, and to do so at a price which reflected the fact that the claimant would no longer have the benefit of the goodwill associated with his loyalty and service. And again, it is just about possible, on the assumption that it is a secondary obligation subject to the rule against penalties, to conclude as Lord Hodge does that, while 'harsh', it was not 'exorbitant', ie in the terms in which the

[72] [2018] UKSC 20; [2019] AC 649 at [105].
[73] Or of error. I am no economist.
[74] [2015] UKSC 67; [2016] AC 1172 at [76] ('The real question is whether any damages have been suffered on account of the breach in circumstances where the price has been adjusted downwards on account of the same breach.')
[75] [2015] UKSC 67; [2016] AC 1172 at [277] ('If an award of damages together with the price reduction which clause 5.1 effects involved double counting, I would expect the price reduction to be credited against the claim for damages').
[76] There is also the question of the relevance of any injunctive relief to restrain any further breach; cf. Day, above n 7, at xx. The conclusion that the claimant was doing no more than protecting its 'legitimate interest', whether by way of a price adjustment (Lord Sumption) or a proportionate remedy (Lord Hodge), is based on the assumption that the restrictive covenants having been breached, the claimant no longer had the benefit of any loyalty from the defendant: hence Lord Sumption's reference to the fact that such loyalty is 'indivisible' and, of course, the effect of Clause 5.6 was to bring about 'the *severance* of the connection between the Defaulting Shareholder and the Company': [2015] UKSC 67; [2016] AC 1172 at [81] (emphasis added).
[77] Summers, above n 2, at 108.

test has been interpreted in this paper, it did not exceed the generous margin afforded to the injured party to determine in advance the extent of its potential loss and therefore extend beyond its performance interest.

Of course, one has to acknowledge that passages in the speeches of their Lordships in the *Makdessi* case suggest that the 'broader approach' advocated therein goes even further than allowing for a generous margin in the protection of the performance interest, conceived of in terms of 'loss'. In addition to Lord Sumption's reference to an interest which extends 'beyond compensation',[78] Lord Mance also observed that: '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.'[79] However, the difficulty with divorcing the test for a penalty from any conception of what the claimant may have lost is that it is not obvious what is being compared when asking if the agreed remedy is 'out of all proportion' or 'exorbitant'; nor why the test should only be applied to clauses responding to a breach. What one is left with is what Lord Hodge described as a 'value judgment'.[80]

That may be the only basis upon which one can explain the *ParkingEye* case which concerned a fine of £85 imposed on a motorist who exceeded the limit of two hours free parking in a retail centre car park operated by the defendant, but owned by a third party. The decision of the whole Court was that the rule against penalties applied to the charge, but that it was not a penalty.[81] One difficulty with this conclusion is that the defendant suffered no financial loss if the claimant breached the obligation to vacate the space within two hours; indeed, its business model required some motorists to breach this obligation in order to provide the income stream which allowed it to cover the costs of operating the car park and make a profit from its services. Lord Sumption concluded that the defendant had a 'legitimate interest…which extended beyond the recovery of any loss',[82] but again it may be more accurate to say that it had an interest which extended beyond any *pecuniary* loss. In this regard, he referred to the interest of the third-party landowner who received a fee from the defendant for the right to operate the scheme and the interest of the retailers and their customers in ensuring a reasonable turnover of parking spaces, and rejected the submission that such third-party interest was irrelevant.[83]

This is, however, an approach to the relevant performance interest which appears to go beyond any previous case.[84] For example, in both the *Dunlop* case and the *Makdessi* case, it was possible to identify a 'loss' but one which 'does not admit of precise proof or calculation'.[85] But what loss of any sort was caused to the defendant by the breach in *ParkingEye*? The decision that the charge did not amount to a penalty can, it seems, only be explained on the basis of the court's willingness to recognise new forms of performance interest, as much as anything to uphold the parties' agreement. That might be thought a case of the tail wagging the dog, or indicate that the real significance of the case is not what it decided in relation to the test for a penalty, but its recognition of new forms of non-pecuniary loss which might legitimately be regarded as the subject of judicial remedy.[86] It may have been preferable to find that the

[78] See above, text to n 9.
[79] [2015] UKSC 67; [2016] AC 1172 at [145].
[80] [2015] UKSC 67; [2016] AC 1172 at [249], [259], [287].
[81] Lord Toulson observed that the argument that the clause was a penalty was 'questionable' but, having decided it was unenforceable as an unfair term under the Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083) (a dissenting judgment), he chose not to discuss the matter further: [2015] UKSC 67; [2016] AC 1172 at [316].
[82] [2015] UKSC 67; [2016] AC 1172 at [99].
[83] [2015] UKSC 67; [2016] AC 1172 at [99].
[84] As far as any third-party interest is concerned, while there are circumstances in which a contracting party may recover for a third party's loss, it is far from clear that those circumstances were present in the *ParkingEye* case: see E Peel, *Treitel: The Law of Contract*, 15th edn (London, Sweet & Maxwell, 2020) paras 14-025-14-044.
[85] *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 at 20 (Lord Robertson).
[86] *cf* Rowan [2019] *CLJ* 148 at [170]-[171]; Day, above n 7, at xx.

rule against penalties did not apply on the basis that the charge was not payable on breach, but represented the price payable for parking in excess of two hours. That would avoid the obvious difficulty associated with a breach from which a party is intended to gain, but Lord Sumption concluded that, 'on reflection', it was not the correct analysis.[87] One concern may have been that to characterise the charge as a 'price' clause would not only have prevented any application of the rule against penalties, but also the test of fairness under the Consumer Rights Act 2015,[88] in any future case where the charge was found to be 'out of all proportion' and therefore extravagant and unconscionable.[89]

SCOPE

It was stated earlier that the test for a penalty advanced herein is consistent with the jurisdictional requirement that the parties' agreement must amount to a 'secondary obligation', ie a clause which is triggered by, and intended to address the consequences of, the breach of a primary obligation. But this does not explain the jurisdictional requirement itself. Why should the courts review the parties' bargain about the scope and extent of their secondary obligations, but not their primary obligations? In *Makdessi* Lord Sumption justified the retention of the rule against penalties, in part, on the need to protect small businesses who fall outside the scope of the legislation designed to protect consumers,[90] but that is an argument in favour of a more general power of review and does not explain why it should be confined to 'secondary obligations'. The only member of the Court to address directly, and seek to defend, the distinction between a primary and a secondary obligation[91] is Lord Mance, when he observed that:[92]

> '…in most cases parties know and reflect in their contracts a real distinction, legal and psychological, between what, on the one hand, a party can permissibly do and what, on the other hand, constitutes a breach and may attract a liability to damages for…the breach'.

It is not clear what exactly is meant by the reference to a 'psychological' distinction, but this paper concludes with one suggestion. It is in the very nature of a secondary obligation that it is a contingent obligation which a contracting party may not be required to perform, whereas it is in the nature of a primary obligation that a contracting party will ordinarily expect to have to fulfil it. To give a very simple example: if D agrees to buy a widget from C which has a market value of £1 for £100, there is no contingency in D's obligation to perform, and this may explain why freedom of contract is applied without qualification, save in cases where C's consent has been vitiated in some way; if, however, D agrees to buy the widget for £1, but agrees that she will pay damages of £100 if she fails to accept and pay on the date agreed, her obligation is a contingent one and she may have agreed to it on the basis that she (optimistically) assumes that she will not be required to perform. Does this justify giving the court a power of review under which it can ensure that D has not agreed to an alternative performance which is 'out of all proportion' to the performance she will, primarily, have been expecting to provide?[93]

Even if it does, what then of the contract in which D has accepted a contingent primary obligation? This is a well-known problem for the scope of the rule against penalties. Again, to give a simple example: if D promises to complete a building by 1 January for C at a price of £10m, but also promises that for

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[87] [2015] UKSC 67; [2016] AC 1172 at [94].
[88] See s.64(1)(b).
[89] The answer to this concern may be to accept that neither the rule against penalties, nor the 2015 Act applies, but control the levying, and level, of the charge under such parking schemes by some other form of regulation.
[90] [2015] UKSC 67; [2016] AC 1172 at [38].
[91] It is largely addressed by Lord Sumption when discussing the decision of the High Court of Australia in the *Andrews* case: see below.
[92] [2015] UKSC 67; [2016] AC 1172 at [130].
[93] *cf* the debate about the power to review 'exception clauses': B Coote, *Exception Clauses* (London, Sweet & Maxwell, 1964).

each week that completion is late, she will pay C the sum of £100k, the rule against penalties may be applied to the latter promise because it amounts to a secondary obligation triggered by the breach of the promise to complete by 1 January; if, however, D promises only to construct the building for a price which depends upon the date of completion, eg £1m if completed by 1 January, £9.9m if completed by 8 January, and so on, the rule against penalties does not apply because D is only ever required to perform the primary obligation to construct the building. And yet, in both cases, D has promised to forfeit £100k per week on a contingent basis, ie depending on the date of completion.

This problem was, of course, not lost on the Court in *Makdessi*. Having decided that clause 5.1 was a price adjustment clause, Lord Sumption observed:[94]

> 'We do not doubt that price adjustment clauses are open to abuse, and if clause 5.1 were a disguised punishment for the Sellers' breach, it would make no difference that it was expressed as part of the formula for determining the consideration. But before a court can reach that conclusion, it must have some reason to do so.'

This passage is not free from difficulty. For example, how can the question posed of whether the clause is 'a disguised punishment for the Seller's *breach*' even arise? The solution to this apparent circularity may lie in a point which has already been considered above. We saw that, notwithstanding the finding that clause 5.1 was a primary obligation, Lord Sumption went on to discuss the claimant's 'legitimate interest' in the observance of the restrictive covenants, when this appears only to be relevant if the rule applies and it is necessary to apply the test. This led to the suggestion that this was done to inform the decision whether clause 5.1 should be regarded as a primary obligation, ie on the hypothesis that the test applies, if the alternative (contingent) performance would be regarded as out of all proportion to the primary performance (a 'disguised punshment'), the clause will be subject to the rule against penalties and will, by definition, amount to a penalty.[95]

This solution is itself not free from difficulty. It too suffers from a degree of circularity in that the test for a penalty is used to determine the scope of the rule which leads to the application of the test. It also leads to the conclusion that any contingent primary obligation may be assessed to see if it amounts to a penalty,[96] but that possibility already exists by virtue of the Court's recognition that the scope of the rule cannot be determined solely by the drafting of the parties and must be a question of substance over form.[97]

CONCLUSION

With a rather neat symmetry, the two leading decisions on the power to strike down penalties, *Dunlop* and *Makdessi*, were decided exactly 100 years apart. The latter has been welcomed for making it 'less likely that that power will be exercised in the context of commercial contracts'.[98] This paper submits that this has been achieved by adopting a broader understanding of the test which is still fundamentally the same: the parties can agree a remedy which allows them a generous margin when compared to the limitations which might be imposed on any judicial remedy, but they cannot impose a remedy beyond that which could conceivably be awarded by the courts. On this basis, it may be more accurate to say

[94] [2015] UKSC 67; [2016] AC 1172 at [77].
[95] See above, text to n 77.
[96] This was said by the Court ([2015] UKSC 67; [2016] AC 1172 at [42]) to be one of the difficulties with the decision of the High Court of Australia in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 in which the jurisdictional requirement of a prior breach was rejected.
[97] This in turn means that, in practice, there may not be that much difference between the approach to jurisdiction of the Supreme Court in *Makdessi* and the High Court of Australia in *Andrews*: see Summers, above, n 2 at 102.
[98] Burrows, *Remedies for Torts, Breach of Contract and Equitable Wrongs*, 4th edn (Oxford, OUP, 2019) 390.

that what really explains the decisions in *Makdessi* and *ParkingEye* is less a broader understanding of the test for a penalty, and more a broader recognition of what constitutes loss.