The rule against contractual penalties in Great Britain and Ireland

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1. Introduction
A contractual clause may provide that a party to the contract, on failing to perform an obligation under the contract, must pay a specified amount of money to the other party to the contract. Such a clause, which will be called 'agreed sum' in this article, may be beneficial in that it absolves the promisee from the need to prove the precise amount of loss suffered as a result of the promisor's breach, and provides the promisor with certainty as to the amount to be paid in the event of breach. However, the penalty may also be dangerous. The stipulated amount may be significantly higher than the loss expected by the promisee, and the promisor may have agreed to the clause only because the promisee had superior bargaining power or the promisor underestimated the risk of breach. The legal systems of Great Britain and Ireland have recognized that the freedom of contracting parties to choose the terms of their contract needs to be restricted in relation to agreed sums. In all member states of the European Union, an agreed sum (like any other clause except core terms of the contract) is subject to laws that invalidate any unfair contract term at least in contracts between a business and a consumer, as a result of implementing an EEC Directive. Apart from this general regulation of unfair contract terms, most European countries have laws that specifically regulate agreed sums and generally do so even if none of the parties is a consumer.

In England and Wales, Scotland and the Republic of Ireland, the specific regulation of agreed sums is effected through the common law doctrine against contractual penalties. An agreed sum is unenforceable (at least to the extent that it exceeds the promisee's actual loss) if it constitutes a penalty, and is enforceable otherwise. Before 2015, all the jurisdictions in Great Britain and Ireland applied the same test to determine whether an agreed sum constitutes a penalty, although the Scottish legislature was contemplating legislation to align Scots law with the position under the European Union's Draft Common Frame of Reference. In 2015, in Caversend Square Holding BV v Makdessi, the Supreme Court of the United Kingdom altered the test for the law of England and Wales. While the Scottish courts immediately adopted the new test, rendering a legislative reform of Scots law in the near future less likely, the courts in the Republic of Ireland have so far refrained from adopting the new test. This article will trace the development of the law in England and Wales (Section 3), Scotland (Section 4) and the Republic of Ireland (Section 5). Beforehand, in Section 2, the common law doctrine against contractual penalties will be compared to the regulation of agreed sums in Continental Europe and transnational instruments.

2. A comparative look at Continental Europe and transnational instruments
The legal systems in Great Britain and Ireland deal with contractual penalties as a matter of the enforceability ab initio of a clause stipulating for an obligation to pay a certain amount of money in the event of breach. The key question is whether the clause constitutes a penalty. This is determined as at the time of the contract. Thus, the court only considers circumstances that were present when the contract was made. Subsequent events, such as the amount of actual loss suffered, are irrelevant. An agreed sum may thus be a penalty even though its amount is less than the actual loss. The criteria employed to determine whether an agreed sum constitutes a penalty will be discussed in the subsequent Sections of this article.

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3. This article focuses on an obligation to pay money as the detriment imposed in the event of breach. The common law doctrine against penalties applies equally to many other forms of detriment such as an obligation to transfer assets or the loss of a claim; see S. Worthington, 'Penalty Clauses', in: G. Virgo and S. Worthington (eds.), Commercial Remedies: Resolving Controversies (Cambridge University Press 2017) 383-387.


5. The law of Northern Ireland will not be discussed separately. The courts in that jurisdiction adopted the Dunlop test, discussed in Section 3.1; see Blacklaw v Lemon [1929] NI 159, 164; Farnhill Properties (Northern Ireland) Ltd v Maguire [2010] NIRC 20 [3]-[17]. It is to be expected that they will now apply the Makdessi test.


7. In those circumstances, the amount of the actual loss seems to be recoverable: Wall v Federatsiebolaget Ljugg Ltd [1919] 3 KB 66; Steria Ltd v Sigma Wireless Communications Ltd [2008] BLR 79 [114]. For criticism, see R. Halsan, Liquidated Damages and Penalty Clauses.

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An agreed sum that does not constitute a penalty is enforceable in its entirety. The court does not have the power to reduce the amount. For the enforceability of penalty clauses, there are differences between the legal systems. In England and Wales, a penalty clause is unenforceable in its entirety. It cannot be enforced in part or under conditions. The aggrieved party is confined to a claim for damages under the general law. In the Republic of Ireland, a penalty clause is unenforceable insofar as it exceeds the actual loss suffered as a result of the breach. Scottish law is similar to Irish law where the obligation breached is an obligation to pay money, but otherwise seems to be the same as the law of England and Wales. Legal systems in Continental Europe deal with contractual penalties in a different manner. Leaving aside the regulation of unfair contract terms mentioned in the Introduction, an agreed sum is never unenforceable in its entirety only because it may constitute a penalty. The starting point of the Continental regime is the enforceability of an agreed sum. This is coupled with the power of the court to reduce the agreed sum to a reasonable amount where the agreed sum is grossly excessive in the circumstances. This power cannot be excluded by agreement. In determining what reduction (if any) is appropriate, the court considers all the circumstances of the case, including events occurring after the conclusion of the contract (in particular the amount of loss inflicted by the breach of contract).

In Germany and Switzerland, the court has the power to reduce an agreed sum only where the agreed sum constitutes a penalty (Vergütungssatz). A penalty must be distinguished from a fixation of the loss (Schaftschuldsatz). The distinction is based on the primary objective of the agreed sum. If the agreed sum is primarily intended to put pressure on the promisor to perform the contract, it will be construed as a penalty. If, on the other hand, the agreed sum is primarily intended to assist the promisee in obtaining compensation for loss, it will be construed as a fixation of the loss. The key question is whether the parties intended to fix the promisee's expected loss. This determination may be a difficult task for a court, as an agreed sum often pursues both objectives. In other Continental countries (for example France, Italy and the Netherlands), the court's power to reduce an agreed sum to a reasonable amount exists for all sums payable in the event of breach. There is no need to distinguish between a penalty and a fixation of loss. On the downside, the promisee cannot be certain that a clause that was intended merely to estimate the loss will be enforced in its entirety.

Transnational instruments have adopted the regime just mentioned: an agreed sum is in principle enforceable but can be reduced by the court, without distinction between a penalty and a fixation of loss. For example, Article III-3:712 of the European Union's Draft Common Frame of Reference (2009) provides:

1. Where the terms regulating an obligation provide that a debtor who fails to perform the obligation is to pay a specified sum to the creditor for such non-performance, the creditor is entitled to that sum irrespective of the actual loss.
2. However, despite any provision to the contrary, the sum to specified in a contract or other juridical act may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and other circumstances.

Almost identical provisions are found in Article 9:509 of the Principles of European Contract Law and Article

10. Cavendish Square Holding BV v Makdessi [2015] UKSC 67, 2016 AC 1172 [87] (Lord Neuberger PSC and Lord Sumption JSC, Lord Carnwath JSC [agreeing], [232]; Lord Hodge JSC, saying that the contrary decision by the Court of Appeal in Johnson v Johnson [1899] 1 WLR 1026 was wrongly decided.
11. Lassension Property Finance Ltd v Burke [2017] IESC 62 [48]-[51].
12. Debt Securities (Scotland) Act 1854, s. 5. See also Wirral Borough Council v Carrey Group plc 1998 SLT 463.
15. Under Article 1231 of the Belgian Civil Code, the court must reduce the amount to the actual or foreseeable loss; see F. Auvray and S. Janvier, 'Belgique - A propos des Clauses Pénales qui ne peuvent être Pénales: Le Critère Distinguc entre les Clauses Pénales Licites et les Clauses Pénales Illicites' (2017) 25 European Review of Private Law 181.
17. § 343 of the German BGB, Article 161(3) of the Swiss Law of Obligations. The power to reduce a penalty under § 343 of the German BGB does not exist where the promisor is a merchant. However, such a penalty may be void at being contrary to public policy under BGB § 138. F. Faust, 'Contractual Penalties in German Law' (2015) 23 European Review of Private Law 285, 292.
18. For German law, see F. Faust, 'Contractual Penalties in German Law' (2015) 23 European Review of Private Law 285, 288. The test is similar to the English test discussed below 3:1.
20. Article 1231-5 of the French Civil Code; Article 1381 of the Italian Civil Code; Article 6.94 of the Dutch Civil Code.

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7.4.13 of the UNIDROIT Principles of International Commercial Contracts 2016. Other transnational instruments also provide that any sum payable on breach by way of penalty or compensation may be reduced by the court if it is 'manifestly excessive' or 'substantially disproportionate in relation to the loss that has been suffered by the obligee'.28

Both the regime in Great Britain and Ireland and the Continental regime thus provide protection against contractual penalties. But they do so in different ways.29 In Great Britain and Ireland, an agreed sum is either enforceable or unenforceable in its entirety, judged as at the time of the contract. It is all or nothing. The Continental regime is more flexible by regarding an agreed sum as generally enforceable but empowering the court to reduce the amount where it is excessive in the light of the circumstances at the time of the court’s decision. This flexibility is to be welcomed, and is not surprising that transnational instruments have adopted the Continental regime.

3. The law in England and Wales

3.1. The rules laid down in Dunlop (1914)

In Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd,30 the plaintiff was the manufacturer of motor tyres, covers and tubes, and supplied these goods to the defendant, a dealer. One of the defendant’s obligations under the contract was not to sell any of the plaintiff’s goods at less than the plaintiff’s current list prices. In Clause 5 of the contract, the defendant agreed to pay to the Dunlop Pneumatic Tyre Co., Ltd., the sum of £. for each and every tyre, cover or tube sold or offered in breach of this agreement, as by way of liquidated damages and not as a penalty. The defendant sold a tyre cover at less than the current list price, and the plaintiff brought an action for an injunction and damages. The defendant argued that Clause 5 of the contract was an unenforceable penalty clause. The House of Lords took a different view.

Each of the four law lords gave his own speech. But all of their Lordships agreed on three matters.31 First, a contractual clause that requires a party to pay to the other party a certain amount of money in the event of breach is either an enforceable liquidated damages clause or an unenforceable penalty clause. Secondly, the use of the term 'liquidated damages' or 'penalty' by the parties is not conclusive for the categorisation of a clause.32 Thirdly, a sum that constitutes a genuine pre-estimate of what the parties, at the time of the contract, could have foreseen as possible damage resulting from breach is not a penalty.

Their Lordships differed in their expression of the precise demarcation line between liquidated damages clauses and penalty clauses. The way in which Lord Dunedin and Lord Parker expressed the test suggests that an agreed sum constitutes a penalty as soon as it exceeds, even slightly, a genuine pre-estimate of damage.33 Lord Parmoor, by contrast, emphasised that unless the obligation breached is one to pay money (in which case the obligation to pay any larger sum on default is a penalty), for an agreed sum to be struck down as a penalty “there must be an extravagant disproportion between the agreed sum and the amount of any damage capable of pre-estimate”.34 Lord Atkinson’s speech is unclear in that respect, although he expressed the view that the contract in case ‘contains nothing unreasonable, unconscionable, or extravagant’.35

Despite these differences, their Lordships agreed that the clause before them was not a penalty. They observed that the reason for the plaintiff requiring its trade customers to adhere to its price list was that if one trade customer undercut the prices, this would quickly become known and other trade customers of the plaintiff would lose custom and might cease selling the plaintiff’s goods and turn to one of the plaintiff’s competitors. It was difficult to foresee the magnitude of the loss that a single sale below the list price would inflict upon the plaintiff, but this factor made it more likely that Clause 5 was a genuine pre-estimate of damage.36

Lord Dunedin gave a succinct outline of the rules relating to contractual penalties, and it is probably for this reason that his speech proved most influential. His outline of the rules ‘achieved the status of a quasi-statutory code in the subsequent case law’.37 Lord Dunedin’s statement ‘The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-esti-
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... was approvedly quoted by the Court of Appeal for England and Wales on many occasions, and by Lord Morton in Bridge v Campbell Discount Co Ltd, where Lord Radcliff and Lord Devlin also said very clearly that a sum payable on breach is penalty unless it is a genuine pre-estimate of damage. The fact that Lord Parmoor in Dunlop had required an extravagant disproportion between the agreed sum and a genuine pre-estimate of damage was rarely mentioned. Instead of permitting the court to make an evaluative judgement on the extravagancy or unconscionability of an agreed sum, the Dunlop test was generally understood as a purely arithmetical comparison between two amounts of money at the time of the contract. Occasionally, the loss actually suffered by the innocent party was also seen as a reference point. Even though it was rare for an agreed sum to be struck down as a penalty, there was growing discontent with the rigidity of the Dunlop test as it had evolved. In particular, it was questioned whether parties dealing at arm’s length were prevented from going beyond a genuine pre-estimate of loss. The criticism was made not only in Great Britain but also in other countries that had adopted the Dunlop test. Perhaps the most trenchant criticism came in the 20th century, when that of Dixon J on behalf of the Supreme Court of Canada.

It is now evident that the power to strike down a penalty clause is a blantly inconsistent with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression. This sentiment was echoed by judges in the High Court of Australia, and by the Judicial Committee of the Privy Council in an appeal from Hong Kong, where Lord Woolf said that the court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld. The Dunlop test was under attack.

3.2. Developments between 1996 and 2014

In a line of cases starting in 1996, the English courts ‘sought to escape the apparent straightforwardness of a dichotomy between a genuine pre-estimate of loss and a penalty’. It was said that an agreed sum that is not a genuine pre-estimate of loss is enforceable if it is commercially justified. A trichotomy of genuine pre-estimate of loss, commercially justified clause and penalty emerged. The first of these cases was Lordsdale Finance plc v Bank of Zambia, where a loan agreement between the defendant borrower and an international syndicate of banks provided for an increase in the interest rate payable in the event of default by the borrower. The increased rate, payable from the date of default, was calculated under a certain formula, which contained an unexplained % discount. The borrower argued that this % was a penalty. Colman J took a different view. He observed that inter-

33. [1915] AC 79, 86.
37. Lord Parmoor’s statement was quoted, but without recognition of its difference to Lord Dunedin’s test, in Country Leasing Ltd v East (2007) EWFC 2907 (QB) [114].
38. Such an evaluative judgement was exceptionally regarded as required in Tullvick Probus Group Ltd v El Hajjali (2008) EWFC 1924 (QB), (2008) IRLR 760 [34].
39. For the relevant date, see Close v Link Ltd v Bryla (2014) ICR 264 [12].
40. Imperial Tobacco Company (of Great Britain and Ireland) Ltd v Parry (1956) 2 All ER 515, 521 (Lord Wright MR); Robobank Facilities Ltd v Blond (1964) 1 WLR 1428, 1446-1447 (Diplock LJ); Export Credits Guarantee Department v Universal Oil Products Co (1983) 1 WLR 399, 403 (Lord Roskill).
41. See Bluestone Energy Services BV v Mercosur Steel Structures BV (2014) EWFC 2132 (TCC), (2014) 155 Con LR 85 [1226]. Where an agreed sum was struck down, there was usually a wide gulf between that sum and the likely amount of damage; see Alfred McAlpine Capital Projects Ltd v Tolichow Ltd [2005] EWFC 281 (TCC), [2005] BLR 271 [48]. It must be considered, however, that many parties may have been deterred from going to court (to enforce an agreed sum) in the first place.
44. Exanda Finance Corporation Ltd v Plessing (1985) 166 CLR 131, 140 (Wilson and Tookey JJ).
45. Amalgamated Corporation Ltd v Marsh (NZ) Corporation Ltd [2004] 2 NZLR 614 [58].
46. The Judicial Committee Act 1833 created the Judicial Committee of the Privy Council as the court of final appeal for the UK overseas territories and Crown dependencies. The major Commonwealth countries have all removed the jurisdiction of the Privy Council.
47. Phillips Hong Kong Ltd v Attorney General of Hong Kong (1993) 61 Build LR 41, 58.
48. Phillips Hong Kong Ltd v Attorney General of Hong Kong (1993) 61 Build LR 41, 59. Similarly, in Robobank Facilities Ltd v Blond [1964] 1 WLR 1428, 1447, Diplock LJ had said that ‘the court should not be auverge to decree a “penalty clause” in every provision of a contract which stipulates a sum to be payable by one party to the other in the event of a breach by the former’.
national syndicated loan agreements invariably provide for increased rates of default interest, that the courts of New York are prepared to enforce them,\(^5\) and that it was undesirable to have a disparity between the laws applicable in London and New York, two major centres of international banking.\(^6\)

Colman J observed that, according to the speeches in Dunlop, a sum payable on breach will be a penalty if its predominant function is to deter a party from breaking the contract rather than to compensate the innocent party for loss.\(^5\) Turning to the clause before him, he said: \(^4^4\)

no reason to deduce that a small rateable increase in interest charged prospectively upon default would have the dominant purpose of deterring default. That is not because there is in any real sense a genuine pre-estimate of loss, but because there is good commercial reason for deducing that deterrence of breach is not the dominant contractual purpose of the term.

Colman J’s approach was followed in a number of first-instance decisions. Like Lordsales, some of these cases involved relatively small increases in interest rates in the event of default.\(^9\) Other cases involved other types of clause, the characterisation of which as a penalty was rejected on the ground that they were commercially justifiable and did not have as their dominant purpose the deterrence of breach.\(^5\)

Moreover, Colman J’s reformulation of the penalty doctrine found support in the Court of Appeal. In *Cine Bes Filmcilik ve Yapimcilik ve United International Pictures*, Mance LJ expressed agreement with Colman J that ‘a dichotomy between a genuine pre-estimate of damages and a penalty does not necessarily cover all the possibilities. There are clauses which may operate on breach, but which fall into neither category, and they may be commercially perfectly justifiable’.\(^5\) Mance LJ’s statement was approvingly cited by the Court of Appeal in *Murray v Lessireplay plc*,\(^7\) where Buxton LJ said, however, that Colman J’s approach in *Lordsales* had not changed the dichotomy between a genuine pre-estimate of loss and a penalty, all that it meant was that every agreed sum that was not intended as a deterrent must be regarded as a genuine pre-estimate of loss.\(^9\)

In *Euro London Appointments Ltd v Claessens International Ltd*,\(^6\) the Court of Appeal, in obiter dicta, adopted Colman J’s approach and rejected a characterisation of the clause in casu as a penalty on the ground that its dominant contractual purpose was not deterrence. The court did not investigate whether the clause was a genuine pre-estimate of loss.

The line of cases in which the dichotomy between a genuine pre-estimate of loss and a penalty was rejected created uncertainty as to the state of the law.\(^4\) The view expressed in these cases conflicted with the many previous decisions by the Court of Appeal and the House of Lords in which the dichotomy had been firmly embraced. Strictly, *Lordsales* and the cases that followed it were wrongly decided.\(^9\) Alongside the new line of cases, there were still cases in which the dichotomy between a genuine pre-estimate of loss and a penalty was maintained.\(^3\)

The lack of clarity in the law is vividly illustrated by the 2009 decision of the Court of Appeal in *Lawsat Shipping Co Ltd v Glencore Grain BV*.\(^5^3\) Lord Clarke MR, speaking for the Court, first said that a sum payable on breach is unenforceable unless it is a genuine pre-estimate of loss, and later expressed agreement with the rejection by Mance LJ in *Cine Bes* of the dichotomy between a genuine pre-estimate of loss and a penalty.\(^3^4\) A clarification of the law by the Supreme Court was needed.\(^7\)

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51. Colman J provided no evidence for this sweeping claim. It would certainly be incorrect to say that under the law of New York a default interest clause can never be a penalty: *Ponter Capital Corp v Matters* [2013] EWHC 3929 (Ch) [151].
55. *Petromercantile v Petrobras* [2004] EWHC 127 (Comm) [184] (increase from 14.25% to 15.25%); *Devonshire Trust plc v Hargold Ltd* [2009] 4 WLUK 368 [32]-[34] (increase from 1.5% to 3%); *North Shore Ventures Ltd v Anteced Holdings Inc* [2010] EWHC 1485 (Ch), [2010] 2 Lloyds Rep 265 [234]-[239] (increase from 15% to 25%).
58. [2005] EWCA Civ 963 [38] (Arden LJ), [106] (Clarke LJ), [110] (Buxton LJ).
59. [2005] EWCA Civ 963 [111].
60. [2006] EWCA Civ 385, [2006] 2 Lloyds Rep 436 [29]-[40].
62. The Court of Appeal for England and Wales is bound by decisions of the House of Lords and the UK Supreme Court and is generally bound by its own decisions: *Davies v Johnson* [1979] AC 264, 323-328, 336, 343-345.
63. *J & J Polymers Ltd v Mersey Minerals Ltd* [2008] EWCA Civ 58, [2008] 2 Con LR 26 [15], [22], [29].
67. In October 2009, the Supreme Court replaced the Appellate Committee of the House of Lords as the highest court in the United Kingdom.
3.3. The law since Makdessi (2015)
In 2015, in Cavendish Square Holding BV v Makdessi,66 the UK Supreme Court reviewed and changed the penalty doctrine. It was a decision on the combined appeals in two cases. In Makdessi, Mr Makdessi sold the majority of shares in a certain company to Cavendish Square Holding BV (‘Cavendish’), the price to be paid in specified instalments. He undertook not to compete with the company for a certain period of time. In the event of breach of this obligation, Clause 5.1 of the contract provided that the last two instalments of the purchase price would no longer be payable, and Clause 5.6 provided that Cavendish could require Mr Makdessi to sell his remaining shares in the company to Cavendish for a price that disregarded the company’s goodwill. Mr Makdessi breached his obligation not to compete with the company, and Cavendish sought to enforce Clauses 5.1 and 5.6 of the contract. Mr Makdessi argued that the clauses constituted unenforceable penalties.

In ParkingEye Ltd v Beavis, ParkingEye Ltd (‘ParkingEye’) managed a car park near a shopping centre. Large signs at the entrance of the car park and inside said that the maximum stay was two hours and that a failure to comply would result in a charge of £85. Mr Beavis parked his car in the car park for almost three hours. ParkingEye demanded payment of £85. Mr Beavis argued that the charge constituted an unenforceable penalty.

The Supreme Court used these appeals for a comprehensive review of the modern penalty doctrine. It considered whether the doctrine should be abolished altogether.67 While the Court recognised that the penalty doctrine restricted freedom of contract,68 it decided to retain the doctrine, for five reasons. First, the penalty doctrine has existed in English law and Scots law for centuries.69

Secondly, rules regulating contractual penalties exist in all common law jurisdictions, in many European countries and in some transnational instruments on contract law.70 Thirdly, the statutory prohibition of unfair contract terms71 applies only to consumer contracts, but professionals and small businesses may be as worthy of legal protection as consumers.72 Fourthly, neither the English Law Commission nor the Scottish Law Commission had recommended the abolition of the penalty doctrine when considering it.73 Finally, the penalty doctrine is consistent with other judge-made doctrines that decline to give full force to contractual provisions, such as relief from forfeiture and the equity of redemption.74 Conversely, the Supreme Court considered whether the scope of the penalty doctrine should be extended to detriments triggered by an event other than a breach of contract. The High Court of Australia had made such an extension for Australian law, based on the view that the penalty doctrine had never been confined to detriments triggered by a breach of contract in either English law or Australian law.75 The UK Supreme Court in Makdessi refused to adopt the same position for English law.76 Lord Neuberger PSC and Lord Sumption JSC, with whom Lord Carnwath JSC agreed, gave four reasons for the retention of the breach requirement.77 First, the equitable jurisdiction to relieve from penalties arose wholly in the context of bonds defeasible in the event of the performance of a contractual obligation, and thus required a breach of that obligation. Secondly, if there was an equitable jurisdiction to relieve from penalties which was wider than the common law jurisdiction, it has left no trace in the authorities since the fusion of law and equity in 1873.78 Thirdly, the High Court of Australia had extended the scope of the penalty doctrine to any clause that aims to secure compensation for the prejudice suffered as a result of the failure of a primary stipulation.

68. [2015] UKSC 67, [2016] AC 1172, [33], [237].
69. [2015] UKSC 67, [2016] AC 1172, [36], [162], [256].
72. [2015] UKSC 67, [2016] AC 1172 [37] (Lord Neuberger PSC and Lord Sumption JSC), [164]-[166] (Lord Mance JSC), [264]-[265] (Lord Hodge JSC). Reference was made to some of the transnational instruments mentioned in Section 2.
73. Reference was made to the Unfair Terms in Consumer Contracts Regulations 1999, which applied before 1 October 2015, and to the Consumer Rights Act 2015, which came into force on 1 October 2015.
76. The Scottish Law Commission’s Report on Penalty Clauses of 1999 is considered below 4.2.
79. [2015] UKSC 67, [2016] AC 1172 [42], [130], [241]. This aspect of Makdessi was applied in Edgworth Capital (Luxembourg) Sarl v Rambles Investments BV [2016] EWC CIV 412, [2017] 1 All ER (Comm) 377 [7], BHL v Leoni ABL Ltd [2017] EWHC 1871 (QB) [46]; Dana Gas PSC v Dana Gas Sukuk Ltd [2017] EWHC 2928 (Comm), [2018] 1 Lloyd’s Rep 177 [71], Holyoake v Candy [2017] EWHC 3397 (Ch) [468].
81. Their Lordships considered these cases that might be thought to form an exception, but concluded that none of the cases did.
but it is difficult to see how compensation comes into the picture in the absence of a breach of contract. Finally, the High Court of Australia had not addressed the major legal and commercial implications of transforming a rule for controlling remedies for breach of contract into a jurisdiction to review potentially all contingent obligations. So the penalty doctrine remained in place and it remained confined to detriments triggered by a breach of contract. But the Supreme Court held that a sum payable on breach is not a penalty only because it aims to deter breach. In particular, the Court rejected the Dunlop dichotomy between a genuine pre-estimate of loss and a penalty, Lord Neuberger PSC and Lord Sumption JSC observed.

The real question when a contractual provision is challenged as a penalty is whether it is a penalty, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both.

To the same effect, Lord Mance JSC said: "There may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden."

The law lords said that the stipulated sum must be compared, not to a genuine pre-estimate of loss, but to the innocent party’s legitimate interest in the defaulting party performing the obligation breached. Lord Neuberger PSC and Lord Sumption JSC said.

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. But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter’s primary obligations.

Expressing the same test, Lord Hodge JSC said:

"The correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party’s legitimate interest in the performance of the contract. Where the test is to be applied to a clause fixing the level of damages to be paid on breach, an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach would amount to a penalty and thus be unenforceable. In other circumstances the contractual provision that applies on breach is measured against the interest of the innocent party which is protected by the contract and the court asks whether the remedy is exorbitant or unconscionable."

Thus, the Supreme Court laid down a two-step test. The first question is whether the impugned obligation is a secondary, as opposed to primary, obligation. In the case of a secondary obligation, it must then be asked whether the detriment imposed on the contract-breaker is out of all proportion to any legitimate interest of the innocent party in the performance of the primary obligation.

The Court then applied the new test to the facts of the two appeals. In relation to the appeal in Beavis, it was common ground that the £85 parking charge was payable on a breach of contract and was not a genuine pre-estimate of loss. But it was not a penalty. The Court identified two objectives of the parking charge: to manage the efficient use of parking spaces in the interests of the retail outlets and their customers; and to enable ParkingEye to meet its cost and make a profit. A sum of £85 was not out of all proportion to those interests. In relation to the appeal in Mabacas, it was clear that neither Clause 5.1 nor Clause 5.6 constituted a genuine pre-estimate of loss, as the obligations imposed by these clauses were additional to Cavendish’s right to recover

87. [2015] UKSC 67, [2016] AC 1172 [32]. Similar statements were made by Lord Mance JSC (at [152]).
88. While the Justices differed as to the precise way in which the test should be worded, they were in truth asserting the same test of disproportion or exorbitance: Lord Patrick Stewart Hodge, ‘Judicial Development of the Law of Contract in the United Kingdom’ (2017) 87 George Washington Law Review 1507, 1608.
89. [2015] UKSC 67, [2016] AC 1172 [335]. Lord Toulson JSC (at [293]) expressly endorsed and highlighted the first sentence of this passage.
compensation for loss suffered. Nevertheless, the Supreme Court held that neither clause was an unenforceable penalty. All of the law lords agreed that, if the obligations imposed by the clauses were secondary obligations, they were not out of all proportion to Cavendish’s legitimate interest in Mr Makedesi not competing with the company the control of which had been passed from Mr Makedesi to Cavendish, as such competition would affect the company’s goodwill to an extent that would be difficult to measure. An important factor in this assessment was the fact that the agreement had been made between informed and sophisticated parties of equal bargaining power.

Lord Neuberger PSC and Lord Sumption JSC took the view that the obligations imposed by the impugned clauses were primary, not secondary, obligations even though they arose on breach of Mr Makedesi’s obligation not to compete with the company. Their Lordships said that Clause 5.1 belonged to the provisions that fixed the price to be paid by Cavendish, the manner in which the price was calculated and the conditions on which different instalments were payable. They said that Clause 5.6 reflected the reduced price which Cavendish was prepared to pay for the shares in circumstances where it could not count on Mr Makedesi’s loyalty. In the view of Lord Hodge JSC, with whom Lord Toulson JSC agreed on this point, there was a ‘strong argument’ that Clause 5.1 constituted a primary obligation, but Clause 5.6 should be construed as a secondary obligation, as otherwise there would be considerable scope for abuse. Lord Clarke JSC said that he agreed with Lord Hodge JSC ‘in having an open mind about clause 5.1, and in concluding that clause 5.6 is a secondary obligation’. Lord Mance JSC said nothing on this issue.

Three law lords took the view that the impugned obligations in Makedesi were primary, not secondary, obligations even though they were triggered by a breach of contract. While three of the other four law lords expressly rejected that categorisation for Clause 5.6, they kept an open mind about Clause 5.1 and thus agreed that an obligation triggered by a breach of contract can be a primary obligation. This makes the penalty doctrine more complex and uncertain, as the Court deviated from the hitherto established meaning of secondary obligation as every obligation triggered by a breach of contract, but failed to define the new, narrower meaning of secondary obligation.

Lord Neuberger PSC and Lord Sumption JSC said that Clause 5.1 was ‘a price adjustment clause’ and ‘not a contractual alternative to damages at law’. Two comments must be made. First, the view that Clause 5.1 merely adjusted the share price to reflect the lower value the shares would have had without the non-competition clause is unconvincing, as the same price reduction applied regardless of the time and severity of the breach, and regardless of whether the breach has caused any loss of goodwill in the company at all. Secondly, the categorisation of an impugned obligation as primary or secondary should not depend upon whether a claim for damages at common law remains available. Even if it does remain available, the impugned clause purports to alter the remedial regime provided for by the common law. For example, where damages in the amount of £1m could be claimed at common law, it should make no difference whether the impugned clause stipulates for a payment of £2m instead of common law damages or whether it stipulates for a payment of £1m in addition to common law damages. Contracting parties should not be able to escape the penalty doctrine by simply stipulating that common law damages remain available.

Since Makedesi, the English courts have been cautious in categorising an obligation triggered by breach as a primary obligation. This is demonstrated by Vivienne Westwood Ltd v Conduit Street Development Ltd. It concerned a lease of retail shop premises for ten years. The parties simultaneously signed a contract of lease and a ‘side letter’. The contract of lease stipulated an initial annual rent of £110,000, subject to rent reviews after five and ten years. In the side letter, the landlord accepted a lower annual rent in steps from £90,000 in year 1 up to £100,000 in year 5, with a cap of £125,000 per year thereafter. The side letter stipulated that if the tenant breached any term of the lease, the landlord could terminate the agreement in the side letter and rent would then retrospectively be payable as if the agreement in the side letter had never existed. The tenant failed to pay one installment of the reduced rent, and the landlord claimed payment of the higher amount of rent stipulated in the contract of lease. The tenant argued that the purported

103. C Curnow Ltd v Kowos (The Heron II) [1966] 2 QB 695, 730-731 (Diplock LJ); Robohome Facilities Ltd v Blank [1966] 1 WLR 1428, 1446 (Diplock LJ); Photo Production Ltd v Securicor Transport Ltd [1990] AC 827, 848-850 (Lord Diplock).

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obligation to pay the higher rent was an unenforceable penalty.

The judge, Timothy Fancourt QC, held that the landlord’s right to terminate the side letter for any breach by the tenant was an unenforceable penalty, as it would require the tenant to pay the higher rent, possibly for many years retrospectively, regardless of the nature and seriousness of the breach.109 The landlord had argued that the obligation to pay a higher rent on termination of the side letter was comparable to the adjustment of the price in *Makdessi*, and was thus a primary obligation.110 Timothy Fancourt QC rejected this argument.111

In this case, the rent payable is increased because of any failure by the buyer (the claimant) to perform any one of its obligations as tenant, regardless of the particular impact of the breach. That is a different case from a reduction of the rent payable for a shareholding in a company upon breach by the seller of a centrally important non-competition obligation.

It is difficult to devise criteria for deciding when an obligation arising on breach of contract is a conditional primary obligation or a secondary obligation. Those criteria should be informed by the rationale of the penalty doctrine. But a convincing rationale (in relation to business-to-business contracts) has not been advanced.113 If proportionality was the criterion, the jurisdiction and validity stages of the inquiry would collapse into one.112 Some commentators have suggested that the penalty doctrine should apply to primary as well as secondary obligations, as a different treatment cannot be justified.114 This would go too far. An application of the penalty doctrine to obligations not triggered by a breach of contract, even if workable, would be too severe an interference with freedom of contract.115 But it is perfectly arguable that the penalty doctrine ought to apply to all obligations triggered by a breach of contract, because it is difficult to explain why some of those obligations should be removed from the scope of the doctrine and because the categorisation of an individual clause ‘is liable to be teleological, influenced strongly by whether a judge thinks it should ultimately be regarded as penal’.116

Turning now to the legitimate interests of the innocent party with which the agreed sum is compared, it is important to note that one of the interests considered by the Supreme Court in *Beavis* was the customers’ interest in finding parking space. This demonstrates that the court may consider non-financial interests and interests of third parties. ‘Thus, a deterrent can be (prima facie) legitimated by the general utility of the business in which the innocent party is engaged’.117 *Beavis* also demonstrates that the court may consider interests not protected by the bargain in the sense that the breaching party had assumed responsibility for them. An innocent party may thus justify an impugned clause by reference to interests and motives that the breaching party did not assume responsibility for and may not even have been aware of when the contract was made. This approach is at odds with the general approach of English contract law. It is preferable to consider only those interests that a reasonable person in the breaching party’s position could have disbelieved at the time of the contract.119

There is uncertainty as to when an interest of the innocent party is legitimate, apart from thetruism that ‘the innocent party can have no proper interest in simply punishing the defaulter’.120 Carmine Conte argues that only an interest in a recognised remedial response (such as compensation or restitution) should be considered legitimate.121 Even more narrowly, Jessica Palmer argues that ‘legitimate interests must be limited to those for which damages

109. [2017] EWHC 350 (Ch), [2017] L & TR 23 (62)-(63). Arguably, relief from forfeiture is a more appropriate doctrine to protect against the consequences of termination. A discussion of this issue is beyond the scope of this article.

110. See [2017] EWHC 350 (Ch), [2017] L & TR 23 (42).

111. [2017] EWHC 350 (Ch), [2017] L & TR 23 (46).


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are recoverable'.122 These views must be rejected. They effectively prohibit parties from contracting out of the remedial regime at common law, but the Supreme Court in Makedessi intended to afford parties more freedom in that respect.123 A clause requiring a party to disgorge any profit made from breach may well pass the legitimate interest test.124 Cathro and Connell suggest that for an interest to be legitimate it ‘must both be reasonable and have some reasonable connection to the primary obligation in question’.125 In their view, an excess baggage fee imposed by an airline for the purpose of funding a bus line would be illegitimate, as there is no reasonable connection between the fact that baggage is heavier than permitted and the operation of a bus line.126 This is not entirely convincing, as the desire to obtain a higher profit through an excess baggage fee must be legitimate, and it should be irrelevant how the airline intends to spend the extra profit. Perhaps, an interest should be considered illegitimate only where it violates public policy. Finally, the determination of whether the impugned obligation is out of all proportion to the innocent party’s legitimate interests will be difficult where those interests go beyond a recognised remedial response; ‘there is no standardised way to value a legitimate interest’.127 Relevant factors will include the significance of the term breached to the innocent party and the severity of the likely consequences of breach to the innocent party and third parties.128 The process by which the contract came about may also be relevant. While the Supreme Court in Makedessi made clear that the penalty doctrine remains concerned with the substance of the contract and that advantage taking is not required,129 its conclusion that the impugned clauses in casu were not penalties was in part based on procedural factors: the parties’ equal bargaining power in Makedessi,130 and the transparency of the penalty notice in Beavis.131 What remains unclear is whether procedural unfairness can lead to the unenforceability of a clause that would otherwise be considered proportionate.132

4. The Law in Scotland

4.1. Case Law

At least since the decision by the House of Lords in Dunlop,133 Scots law has had the same rules on contractual penalties as the law in England and Wales.134 Prior to the UK Supreme Court’s decision in Makedessi,135 the Scots courts applied the Dunlop dichotomy between liquidated damages clauses and penalty clauses, and categorised a sum payable on breach of contract as a penalty unless it constituted a genuine pre-estimate of the likely loss resulting from breach.136 The courts usually cited the test pronounced by Lord Dunedin in Dunlop,137 and rarely the test pronounced by Lord Parma in Dunlop.138 In Makedessi, Lord Hodge JSC (who is one of the two Scottish judges on the UK Supreme Court) expressed the view that the Supreme Court’s decision in Makedessi

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123. Even under the Dunlop test, it was accepted that the amount of likely loss with which the stipulated sum was to be compared could include items of loss in respect of which damages would not be awarded: Robophone Factories Ltd v Blank (1966) 1 WLR 1428, 1447-1448 (Diplock LJ).

124. A. Summers, ‘Unresolved Issues in the Law on Penalties’ [2017] Lloyd’s Maritime and Commercial Law Quarterly 95, 112. At common law, such disgorge can be ordered only in very exceptional circumstances; see Attorney General & Blake [2001] 1 AC 268.


138. Both tests were regarded as identical in Strathyre Regional Council v Neil 1983 SLT (Sh Ct) 89, 93.
would affect Scots law too. The Scots courts have indeed adopted the Makdessi test. An example is Indigo Park Services UK Ltd v Watson, the facts of which were similar to those of Beavis, the companion case of Makdessi. The operator of a hospital car park demanded payment of a £40 parking charge plus £96 enforcement costs from a motorist who on several occasions had used the car park without displaying a parking ticket. The motorist argued that the term imposing the obligation to pay the charge and enforcement costs was an unenforceable penalty clause. Applying the Makdessi test, the court asked whether the obligation to pay the charge and enforcement costs was payable on a breach of contract (which the court held it was) and whether the obligation was out of all proportion to the car park operator’s legitimate interest in the performance of the contract and in managing the use of car park spaces in a manner that benefited the staff and visitors of the hospital. The court held that the obligation was not disproportionate. The Inner House of the Court of Session (the highest court in Scots civil cases below the UK Supreme Court) followed Makdessi in Grey v Braid Group (Holdings) Ltd. A 6.8.1 of a holding company’s articles of association empowered that company to compulsorily acquire at the ‘Sale Price’ the shares of any shareholder who ceased for whatever reason to be a director or employee of the holding company or a group company. A 6.8.2.2 provided that if the leaving shareholder’s employment had been terminated on the ground of gross misconduct, the Sale Price was 75% of the fair value of the shares, or their subscription price, whichever was less. It was argued that A 6.8.2.2 was an unenforceable penalty clause. While the Inner House was split as to the eventual decision on that issue (the majority holding that it was not a penalty), the three law lords applied the same test. Citing Makdessi, they asked whether A 6.8.2.2 was a secondary obligation (to which they all gave an affirmative answer) and whether the holding company’s right to acquire the shares of a bad leaver at subscription price rather than value was out of all proportion to the company’s legitimate interest in its shareholders performing their duties as directors or employees. The Inner House thus accepted that the rules laid down by the UK Supreme Court in Makdessi represented Scots law too. The Inner House also shared the Supreme Court’s view that an obligation triggered by a breach of contract can be a conditional primary obligation rather than a secondary obligation. When explaining why A 6.8.2.2 was a secondary obligation, Lord Menzies contrasted it with Clause 5.1 in Makdessi. In Makdessi, he said, a large amount of the sale price reflected goodwill, and Clause 5.1 adjusted the price in the event of the vendor breaching the non-competition clause and thereby affecting the company’s goodwill. By contrast, A 6.8.2.2 is not a mechanism for fixing share prices at the date of the agreement ... but rather a mechanism for determining the consequences of a subsequent default, which may occur many years later. Lord Menzies seems to have agreed with the categorisation of Clause 5.1 in Makdessi as a conditional primary obligation, a categorisation that he ascribed to the ‘UK Supreme Court’ even though it had been endorsed by only three of the seven law lords. More significantly, Lord Brodie in Grey said that A 6.8.1, the understandable object of which would appear to be to retain the share capital of the company and the voting power associated with it in the hands of the active participants, was a conditional primary obligation. He gave no explanation other than to observe that while A 6.8.2.2 applied only to a shareholder who has been in breach of contract, A 6.8.1 applied to any shareholder ceasing to be a director or employee ‘for whatever reason’. Lord Brodie seems to be saying that an obligation that can be triggered by an event other than a breach of contract cannot be a secondary obligation, even if it can also be triggered by a breach of contract.

4.2. Consideration of Law Reform

In the late 1990s, the Scottish Law Commission (a body that makes recommendations for legislative law reform) consulted on whether the law on penalties should be changed through legislation. In its Report of 1999 on the matter, the Commission levelled two criticisms against

140. 2017 GWD 40-610.
141. Another recent Scots case involving charges for parking without permit is Vehicle Control Services Ltd v Mackie 2017 SLT (5th Cts) 111. The penalty issue was not raised in that case. The court (at (17)) still cited Makdessi in another context.
142. 2017 GWD 40-610 [95]-[97].
143. 2017 GWD 40-610 [99]-[102]. The court (at [103]-[110]) also held that the impugned term was not unfair pursuant to s 62(4) of the Consumer Rights Act 2015.
146. [2016] CSIH 68, 2017 SC 409 [112] (Lord Brodie), [125] (Lord Malcolm). Lord Menzies (at [34]) took the view that A 6.8.2.2 was exorbitant and unconscionable.
147. [2016] CSIH 68, 2017 SC 409 [82] (Lord Menzies), [106] (Lord Brodie). Lord Malcolm said nothing expressly on this issue, but he would have made it clear had he regarded A 6.8.2.2 as a conditional primary obligation. A similar bad leaver provision was categorised as a conditional primary obligation (in obiter dicta) in the English case Richards v IP Solutions Group Ltd [2016] EWHTC 1835 (QB) [84]-[85].
149. [2016] CSIH 68, 2017 SC 409 [82].
150. [2016] CSIH 68, 2017 SC 409 [81]-[82].
the then existing law on penalties (the Dunlop test). First, ‘it can lead to perfectly legitimate and reasonable penalty clauses being held to be unenforceable’.\(^{154}\) Secondly, ‘it does not allow any judicial control over exorbitant clauses which are the functional equivalent of penalty clauses but which are drafted in such a way that they come into operation on the occurrence of something other than a breach of contract’.\(^{155}\) The Commission recommended legislative reform. The key features of the legislation it proposed are that a penalty clause is unenforceable if the stipulated penalty is manifestly excessive, judged as at the time enforcement is sought, but that the court has the power to modify a manifestly excessive penalty (by, for example, reducing its amount or attaching conditions to its enforcement) so as to make it enforceable.\(^{156}\) The Commission thus recommended bringing Scots law in line with the position in many Continental countries and transnational instruments, as explained in Section 2.

In 2010, the Scottish Government consulted on a draft Penalty Clauses (Scotland) Bill,\(^{157}\) which was drafted in the way recommended by the Scottish Law Commission. The responses to the consultation were mixed,\(^{158}\) and the Scottish Government asked the Commission to undertake further work as part of its current review of contract law.\(^{159}\)

The Scottish Law Commission started a new consultation on penalty clauses in November 2016,\(^{160}\) one year after the UK Supreme Court’s decision in Makdessi. In its Discussion Paper, the Commission noted the change in the law (in England and Wales as well as Scotland) as a result of Makdessi.\(^{161}\) It also noted the position under the European Union’s Draft Common Frame of Reference (2009),\(^{162}\) which is discussed in Section 2. In line with that position, the Commission expressed a tentative view that there should be legislation that makes a penalty clause generally enforceable (without prejudice to the control of unfair terms in consumer contracts),\(^{163}\) but gives the court the power to modify it if the penalty is excessive.\(^{164}\)

The Commission invited comments on the details of its tentative view and on the alternatives to it, which were the simple abolition of the penalty doctrine (without a new regime replacing it) and the absence of any new legislation on penalty clauses, leaving the law as it is.\(^{165}\)

In its Report of 2018, the Commission expressed the view that the UK Supreme Court’s decision in Makdessi had moved the law in England and Wales as well as Scotland closer to the position generally in the rest of Europe and in the Draft Common Frame of Reference.\(^{166}\) The Commission noted that ‘the consultation responses showed no appetite for outright abolition of the penalty doctrine, and a fairly consistent view that the Supreme Court decision should be given bedden-in time’.\(^{167}\) The Commission did not recommend legislative reform or abolition of the penalty doctrine at this time.\(^{168}\)

While it is to be regretted that the Scottish Law Commission has moved away from its 1999 recommendation to bring Scots law in line with the position in many Continental systems and transnational instruments, it is understandable that the Commission wished to see the full impact of Makdessi in Scots (as well as English) law before deciding whether to recommend legislative action. The Commission was right to say that Makdessi had moved English law and Scots law closer to the position in Continental Europe and in the Draft Common Frame of Reference. By making it harder for the courts to refuse to enforce a contractual clause under the penalty doctrine,\(^{169}\) the UK Supreme Court’s decision in Makdessi has rendered it less likely that a clause that would be enforceable in Continental systems will be unenforceable in English law or Scots law.\(^{170}\) To a large extent, this addresses the first concern that the Scottish Law Commission expressed in its Report of 1999 on the penalty doctrine as it then stood. But Makdessi did not address the Commission’s second concern, which is the circumvention of the penalty doctrine by disguising what is in substance a penalty as a detriment arising on the occurrence of something other

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154. Scottish Law Commission, Report on Penalty Clauses (Scot Law Com No 171, 1999) [2.9].
156. Scottish Law Commission, Report on Penalty Clauses (Scot Law Com No 171, 1999) [3.10].
162. Scottish Law Commission, Discussion Paper on Penalty Clauses (Scot Law Com DF No 162, 2016) [2.26].
163. Scottish Law Commission, Discussion Paper on Penalty Clauses (Scot Law Com DF No 162, 2016) [4.30]-[4.35].
164. Scottish Law Commission, Discussion Paper on Penalty Clauses (Scot Law Com DF No 162, 2016) [5.30]-[5.31].
165. Scottish Law Commission, Discussion Paper on Penalty Clauses (Scot Law Com DF No 162, 2016) [1.10].
169. It has been said that the Supreme Court in Makdessi went as near to abolishing the penalty doctrine as it could without expressly saying so. S. Worthington, ‘Penalty Clauses’, in G. Virgo and S. Worthington (eds.), Commercial Remedies: Resolving Controversy (Cambridge University Press 2017) 669.
170. It has been said that the difference between the text in the Draft Common Frame of Reference and the Makdessi test ‘may be imperceptible’. B. Lindsay, ‘Penalty Clauses in the Supreme Court: A Legitimously Interesting Decision?’ (2016) 20 Edinburgh Law Revie 204, 210.
than a breach of contract. In *Makdessi*, the UK Supreme Court re-affirmed that the modern penalty doctrine applies only to detriments triggered by a breach of contract.\(^{172}\) For example, the punitive halving of the fee for a service in the event of the late provision of the service may be disguised by stipulating that half of the intended fee is the regular fee and that the fee will be doubled if the service is provided before a certain date. An extension of the penalty doctrine to detriments not triggered by a breach of contract would require legislation, although such a reform is not desirable as it would turn the penalty doctrine into a general control of unfair contract terms.

5. The law in the Republic of Ireland

After the decision by the House of Lords in *Dunlop*,\(^{173}\) the Irish courts have adopted the same test.\(^{174}\) Clauses that purport to impose an additional obligation in the event of breach have been struck down as a penalty unless they constitute a genuine pre-estimate of loss. An example is *Irish Telephone Rentals v ICS Building Society*,\(^{175}\) where the hire of a telephone paging system repudiated the contract. In such an event, the contract required the hirer to pay 'as liquidated damages' 75% of the remaining rent less 5% for accelerated payment. Costello J found that an amount of 71.25% of the outstanding rent could not be a genuine pre-estimate of loss and was thus a penalty.\(^{176}\)

In 1998, the Irish Supreme Court applied the *Dunlop* test in *Pat O’Donnell & Co Ltd v Truck and Machinery Sales Ltd.*\(^{177}\) A clause in a contract for the sale of goods provided that interest of 2.5% per month was payable immediately on overdue accounts. The Supreme Court struck the clause down as a penalty. The Court held that the loss suffered from a failure to pay a fixed sum of money is that sum plus interest at a 'commercial rate'.\(^{178}\) An annual rate of 30% was not a commercial rate of interest.\(^{179}\) Barron J, with whom O’Flaherty J and Lynch J agreed, said:\(^{180}\)

The guiding principle is that for failure to pay a fixed sum the contract may not provide for the payment of a larger sum. And payment of a rate of interest in excess of the commercial rate includes in it a requirement that the payee should in effect pay a larger sum in respect of liability of a smaller sum.

In 2012, in *ACC Bank plc v Friends First Managed Pension Funds Ltd.*,\(^{181}\) Finlay Geoghegan J in the Irish High Court considered whether she should follow the English line of cases, starting with *Lordsvale Finance plc v Bank of Zambia*,\(^{182}\) in which it had been held that a commercially justifiable clause was not a penalty even if it was not a genuine pre-estimate of loss. Finlay Geoghegan J said that while the Irish High Court was bound by the *Dunlop* principles, the decision in *Lordsvale* 'may not be a departure from such principles, but rather, a modern application of them to the banking sector'.\(^{183}\) Like *Lordsvale*, the case involved an additional rate of interest payable by a borrower in default. The default rate was 0.5% per month. Finlay Geoghegan J held that this was not a genuine pre-estimate of loss.\(^{184}\) She also held that it did not come within the category of 'minimal increase' accepted as being enforceable in *Lordsvale*.\(^{185}\) She concluded that even if it was permissible for the Irish High Court to follow the approach taken in *Lordsvale*, the default interest rate in the case before her could not be regarded as commercially justifiable.\(^{186}\)

After the UK Supreme Court's decision in *Makdessi*,\(^{187}\) the Irish courts have considered whether to adopt the principles laid down in that case. The question was first raised in the Irish High Court in *Sheehan v Breccia*,\(^{188}\) which involved a default rate of interest of 4%. Haughton

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171. [2015] UKSC 67, [2016] AC 1172 [42], [130], [241].
173. The Irish law on contractual penalties is discussed by PA McDermott and J McDermott, *Contract Law* (2nd edn., Bloomsbury 2017) [23.308]-[23.345].
175. [1992] 2 IR 525, 539. See also *Durkan New Homes v Minister for the Environment, Heritage and Local Government* [2014] 2 IR 440 [37].
183. [2012] IEHC 435 [89].
185. [2012] IEHC 435 [90]. A default interest rate of 12% was struck down as a penalty in *Allied Irish Bank plc v Faby* [2014] IEHC 244 [86].
J held that this rate constituted a penalty, following ACC Bank plc v Friends First Managed Pensions Funds Ltd. His Honour noted the new decision in Makdessi, and said that the impugned clause 'could well be' enforceable if the Makdessi test were applied. However, he said that while there were 'attractions to the reasoning in Makdessi, it was for an appellate court to decide whether the Makdessi test should be adopted in Irish law.' His Honour repeated this view in the related case Flynn v Brescia. Sheehan v Brescia went to the Irish Court of Appeal. In the meantime, an adoption of the Makdessi test was argued before the Irish Supreme Court in Launceston Property Finance Ltd v Burke. The issue did not require to be determined and was left open by the Supreme Court. Nevertheless, McKeechnie J, speaking for the Court, described the test laid down in Makdessi, and observed that the Dunlop principles had been applied by Haughton J in Sheehan v Brescia and Flynn v Brescia. McKeechnie J then said:

Thus the traditional perspective continues to be applied in this jurisdiction, and the test under Irish law, as it presently stands, has now diverged from that applicable in England and Wales. A modest caveat to that, however, should be entered: it is that Haughton J saw some merit in the new UK approach. However, he stopped short of outright endorsing it, much less applying it, preferring instead to leave it to an appellate court to consider whether a recalibration of the Irish test is required.

I shall take this opportunity and say, though clearly obiter, that I am not immediately convinced that any change to the test is necessary, nor that the route taken by the UK Supreme Court is necessarily a superior one. I stress that the live debate must be left over for a more suitable case, if and when that should arise.

Subsequently, the Irish Court of Appeal delivered its judgment in Sheehan v Brescia. It upheld Haughton J's decision that the default interest rate in that case was a penalty. The Court of Appeal applied the Dunlop test. After noting the Irish Supreme Court's decisions in Pat O'Donnell & Co Ltd v Truck and Machinery Sales Ltd and Launceston Property Finance Ltd v Burke, Finlay Geoghegan J, speaking for the Court of Appeal on this issue, said:

The High Court and this Court remain bound in accordance with the Supreme Court judgment in Pat O'Donnell to apply the Dunlop principles in determining whether the surcharge interest clause is or is not a penalty. In so stating I do not wish to be taken as indicating that a reconsideration of those principles in the 21st century by the Supreme Court certainly insofar as they relate to additional default or surcharge interest may not be desirable. However, that remains a matter for the Supreme Court in this jurisdiction.

In the Republic of Ireland, all courts below the Supreme Court will thus continue to apply the Dunlop test unless and until the Supreme Court rules otherwise or Parliament intervenes.

It is interesting to note that McKeechnie J in Launceston Property Finance Ltd v Burke gave two reasons for his reluctance to endorse the Makdessi test: that a replacement of the Dunlop test may not be necessary and that the Makdessi test may not be superior. The first reason is somewhat surprising, considering the widespread criticism of the Dunlop test in a number of common law jurisdictions. The second reason is less surprising. While the Makdessi test has made it harder for courts to strike down a clause as a penalty, it has introduced a number of uncertainties, as demonstrated above. If the Dunlop test is considered appropriate for the conditions in Ireland, as implied by McKeechnie J, a replacement with a less certain test will not be appealing.

6. Conclusion
Throughout the last century, all jurisdictions in Great Britain and Ireland had the same rules on contractual penalties, as laid down by the House of Lords in 1914 in Dunlop for the law of England and Wales and subsequently adopted in Scotland and Ireland. A sum payable on breach was an unenforceable penalty unless it was a genuine pre-estimate of loss. This test attracted criticism in a number of common law jurisdictions for its unnecessarily wide restriction of freedom of contract. In its 2015 decision in Makdessi, the UK Supreme Court made it harder for a clause to be struck down as a penalty.

188. (2016) IEHC 62 [127].
189. (2016) IEHC 67 [54].
190. (2016) IEHC 67 [118].
192. (2016) IEHC 68 [48].
194. The impugned obligations in that case were the obligations to pay the arrangement fees and normal interest rates under a loan contract. These obligations did not arise on a breach of contract and thus were not subject to the penalty doctrine. (2017) IESC 62 [44]-[45].
198. In First Active plc v Cunningham (2018) IESC 11 [58], the Supreme Court reiterated, again obiter, that for the time being the Dunlop test continues to apply in Ireland.
in the law of England and Wales, by holding that a sum payable on breach is an unenforceable penalty only if it is a secondary obligation and is out of all proportion to the innocent party's legitimate interests in the performance of the contract, those interests not being confined to compensation for loss suffered. There are a number of uncertainties with the new test, which will have to be resolved in future cases.

In 1999, the Scottish Law Commission recommended a legislative reform of Scots law so as to give courts the power to reduce a manifestly excessive penalty and bring Scots law in line with the position in many Continental countries and transnational instruments. The Scottish Parliament considered implementing this recommendation, but referred the matter back to the Commission. In 2018, the Commission expressed the view that the intervention of Makdessi (which had been immediately adopted for Scots law) had reduced the need for legislative reform and that the decision should be given 'bedding-in time'. This is regrettable, as the Makdessi test still requires the court to choose between validity and invalidity of the clause as a whole, preventing an enforcement of the clause in part or under conditions. The flexibility of the Continental regime is preferable.

The Irish Supreme Court has not yet been required to decide whether the Makdessi test ought to be adopted in Irish law. However, in an obiter dictum, the Court has said that it was not 'immediately convinced' that the Dunlop test needs to be replaced or that the Makdessi test is superior. The lower courts in Ireland will continue to apply the Dunlop test unless and until the Supreme Court rules otherwise or Parliament intervenes.

The UK Supreme Court's decision in Makdessi halted a process in Scotland that might have led to a legislative reform of Scots law and a divergence from the law of England and Wales. Makdessi thus fostered a continued uniformity of the law on contractual penalties in Great Britain. At the same time, the continued application of the Dunlop test by the courts in the Republic of Ireland has created a divergence of the law in Great Britain from the law in the Republic of Ireland. It remains to be seen whether the law on contractual penalties will ever again be uniform throughout those islands.