NEW VARIATIONS ON THE RULE AGAINST PENALTIES: OPTIONS FOR NEW ZEALAND

SAM CATHRO* AND SIMON CONNELL**

As a consequence of the rule against penalties, contractual clauses with a penal character are unenforceable. The rule has recently undergone significant revision in both the United Kingdom and Australia, following decisions by the highest courts in those jurisdictions. This article sets out and considers the options that those decisions put forward for the development of the rule against penalties in New Zealand. The variants are presented in terms of answers to two questions. The first is the “engagement question”: which kinds of contractual clauses are capable of being subject to the rule against penalties? At first glance, the English and Australian authorities present different answers to this question. However, we argue that their answer is essentially the same – the clause must be a secondary obligation triggered by failure to perform a contractual promise. We suggest the English framing of the engagement question should be followed in New Zealand, primarily because it is clearer. The second question is the “test question”: given that a clause engages the rule, what is the test for whether the clause is penal? The new cases are in agreement that a clause is a penalty if it is out of proportion to a legitimate interest in the performance of the contract, but two competing approaches emerge as to what can qualify as such an interest. We call the narrower approach the “bargain approach”; it focuses on interests that are protected by the parties’ bargain, and we argue it is preferable for this reason. However, on the broader approach, which we call the “party purposive approach”, the courts can look further to the innocent party’s motives for entering into the contract. This approach has overwhelming judicial support, and is more likely to be adopted in New Zealand.

I. INTRODUCTION

A. Focus and Structure of this Paper

The rule against penalties1 is an ancient2 contract law doctrine that allows a court to find that certain contractual clauses are unenforceable. We will refer to such clauses as “penalties” or “penal”. The question whether a clause is penal usually arises in the context of agreed remedies clauses. Agreed remedies clauses state (or, at least, purport to state) what will happen when one party (the “breaching party” in contrast to the “innocent party”3) fails to perform a contractual obligation. Absent an agreed remedies clause, the question of what (if any) sums are payable following a particular breach is determined by the law of contract damages.4 Two points are clear. First, agreed remedies clauses

---

* LLB(Hons), University of Otago.
** Lecturer in law, University of Otago.
1 Sometimes referred to as the “penalty rule” or “penalty doctrine”.
2 Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [3] per Lords Neuberger and Sumption who stated that “The penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well …”.
3 References to the “breaching party” herein encompass breaches of primary obligations that may strictly be said not to constitute breach of contract.
4 More broadly, by the law relating to remedies for breach of contractual obligations. For the purposes of this article, we will focus on damages.
that are a genuine pre-estimate of the loss that the innocent party will suffer because of the breach (“liquidated damages clauses”) are enforceable. Second, agreed remedies clauses that have been crafted for the purpose of punishing the breaching party by making them pay a sum far above and beyond any losses actually suffered by the innocent party are penalties. Articulating exactly where the line is drawn between the two has proven difficult.

Until relatively recently, courts operated on the basis of a dichotomy between liquidated damages clauses and clauses which went beyond compensating for loss and were held to be illegitimate deterrents. This follows Lord Dunedin’s classic statement in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* that:

> 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-estimation of damage.

We will refer to this approach as the “traditional *Dunlop* approach”.

This orthodoxy has been disrupted by three recent decisions on the issue. *Andrews* and *Paciocco* are from the High Court of Australia and *Cavendish* and *ParkingEye* are a pair of cases that were decided together in the Supreme Court of the United Kingdom. These recent developments in high-level appellate courts overseas raise the question how New Zealand should approach the issue. The New Zealand Court of Appeal in *Torchlight* had occasion, due to a choice of law clause, to consider and apply the new Australian formulation of the rule against penalties. Thus, the question of the future of the rule against penalties in New Zealand is still open. This paper will focus on identifying the possible approaches that New Zealand can adopt in light of the recent developments in *Andrews*, *Paciocco* and *Cavendish*.

With that goal in mind, there are some matters that fall outside the scope of this paper. We will not concern ourselves with the question of the correct interpretation of *Dunlop*, which can be re-read in light of these new decisions as having been consistent with them all along. The penalty rule has a long history and we will only touch on the history of the rule to the extent that it assists in elucidating and choosing between the versions of the rule that exist today. In

---


7. *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205; *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28; *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373. We will refer to *Cavendish* and *ParkingEye* collectively as “*Cavendish*”; references to *ParkingEye* draw specifically on the facts of that appeal.

8. *Wilaci Pty Ltd v Torchlight Fund No 1 LP* [2017] NZCA 152, [2017] 3 NZLR 293. Leave to appeal to the Supreme Court was denied, see *Torchlight Fund No 1 LP v Wilaci Pty Ltd* [2017] NZSC 112.


10. See for example *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28 at [141]–[156]; *Wilaci Pty Ltd v Torchlight Fund No 1 LP* [2017] NZCA 152, [2017] 3 NZLR 293, at [79].
particular, we take the position that the equitable heritage of the rule, through part of the legal history of the doctrine, is not of particular assistance with respect to determining how the rule should be configured in modern New Zealand.\(^{11}\)

In the course of argument in Cavendish, the question was raised whether the rule against penalties should operate at all, especially between commercial parties.\(^{12}\) We will assume that that position is untenable. That both the Supreme Court of the United Kingdom and the High Court of Australia have decided that the rule still serves a useful purpose suggests that New Zealand is likely to follow that approach. The more important discussion is where the rule draws the line.

ParkingEye and Paciocco also considered whether the clauses in question were in breach of consumer protection legislation.\(^{13}\) It may well be that some clauses that are not penalties will still be caught by New Zealand’s consumer protection laws,\(^{14}\) but the substance of those laws falls outside the scope of this article. Finally, we will not address whether penalty clauses are void in their entirety, as is the case in the United Kingdom,\(^{15}\) or partially enforceable, as is the case in Australia.\(^{16}\)

The substantive content of the article is focused on two questions, and the options these questions provide for New Zealand. The first is the “engagement question”: which sorts of clauses can be penalties? Not all clauses have the potential to be penalties. For example, someone who has got caught up in the excitement of an auction and over-bid on a house cannot have the contract set aside on the basis that the purchase price is so excessive that it is a penalty. Rather, to engage the rule against penalties, a clause must be triggered by a breach of some sort of contractual obligation. This question is a necessary preliminary question. However, New Zealand’s approach to it is likely to be uncontroversial. The second question is the “test question”: having established that a particular clause engages the rule against penalties, what is the test that the court must apply

---

11 See Nettle J in Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [252]: “Medieval religious scruples against usury associated with a primitive agrarian economy do not provide a satisfactory basis on which the penalty rule might now be sustained. Nor is the function of the penalty rule adequately explained by the concerns of courts of equity …”.

12 Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [256]–[260]. Essentially, the arguments against the rule were that it is contrary to freedom of contract, it only applies on breach, it can potentially be circumvented by clever drafting, it is uncertain, and it overlaps with consumer protection legislation. See also Jonathan Morgan “The Penalty Clause Doctrine: Unlovable But Untouchable” (2016) 75 CLJ 11 and David Hope “The Law on Penalties – A Wasted Opportunity” (2016) 33 JCL 93. Note also that the Court of Appeal in Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR at [91] stated that the rule against penalties would not lightly be deployed to set aside terms agreed by commercially astute entities.

13 Indeed, Lord Toulson would have decided the ParkingEye appeal in favour of the breaching party with reference to the Unfair Terms in Consumer Contracts Regulations 1999 (UK), see Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 [295]–[316].

14 For example, a term in a standard form consumer contract that is not penal might still be unenforceable on the basis that it has been declared to be an unfair contract term under the procedure set out in the Fair Trading Act 1986, ss 26A, 46H–46M.


16 Andrews v Australia and New Zealand Banking Group Ltd [2012] HCA 30, (2012) 247 CLR 205 at [10]. More specifically, the clause will be enforceable to the extent that it reflects the loss suffered by the innocent party as a result of the failure of the primary stipulation. We will explain this terminology in Part II.
to determine whether or not the clause actually is a penalty? This question poses the most difficult problem for New Zealand courts.

This paper is divided into three parts. The first is this introductory section, which concludes by briefly setting out the facts and outcomes in the recent cases, clarifying that the rule against penalties is an inquiry into substance, and explaining the need for a new consideration of the penalty doctrine in New Zealand. Part II is concerned with the engagement question. That discussion focuses on whether a clause must be triggered by a breach of contract in order to be a penalty. The Supreme Court of the United Kingdom and the High Court of Australia adopted apparently contradictory approaches on this issue, but we conclude that New Zealand will almost certainly adopt the United Kingdom’s approach. In practice, both approaches only allow clauses triggered by a failure to perform a primary obligation to engage the rule, but this is far clearer on the United Kingdom’s approach. Part III is concerned with the test question. We will argue that there are two competing approaches to the test question (which we call the “bargain approach” and the “party purposive approach”), and that New Zealand should adopt the former, despite the fact that the latter has overwhelming judicial support.

B. The Recent Cases

1. Andrews

Andrews concerned fees that ANZ Bank charged its customers. The fees were triggered, inter alia, when a customer’s cheque bounced, or when a customer overdrew their account. The customers argued that the fees were penalties, while ANZ maintained they were enforceable. The Federal Court of Australia had held that some of these actions (or omissions) by the customer were not properly characterised as breaches of contract. The High Court of Australia concluded in Andrews that clauses which were not triggered by breach of contract could nevertheless engage the rule. The Court did not address whether the clauses were actually penalties.

2. Cavendish and ParkingEye

In Cavendish the Supreme Court of the United Kingdom delivered two concurrent judgments: Cavendish Square Holding BV v Makdessi, and ParkingEye Ltd v Beavis. The Supreme Court rejected the approach to the engagement question taken in Andrews, and formulated its new approach to the test question.

The Cavendish appeal concerned the sale of a large company, and in particular the validity of two clauses which were triggered by breach of a restraint of trade clause by the seller. The first clause allowed the purchaser to withhold payments, while the second clause required the seller to sell his shares in the company to the purchaser. Some of the judges took different views as to whether the clauses in the sale contract were part of the parties’ primary obligations or whether they were

19 Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [32], [152], [255].
secondary obligations. Lords Neuberger, Sumption and Carnwath concluded that they were primary obligations and therefore the rule was not engaged.\(^{20}\) The other judges did not focus on whether the clauses were properly classified as primary or secondary, but rather concluded that they reflected the goodwill of the business, and were therefore in any event not out of proportion to a legitimate objective.\(^{21}\) Overall, the court concluded that neither clause was a penalty.

ParkingEye related to the operation of a car park. The terms of the car park contract allowed the customer two free hours of parking, but imposed an £85 fee on any customer who stayed for longer than two hours. Beavis overstayed the two-hour free parking period and was charged the fee, but claimed it was a penalty and was therefore unenforceable. Although it was accepted that ParkingEye suffered no loss from Beavis’ breach of contract, the Court concluded that the fee was not a penalty. This was in part because ParkingEye was entitled to have measures in place which ensured there would be spaces free for new customers.

3. Paciocco

Paciocco was part of the same litigation with which Andrews was concerned. In Paciocco, the Court considered the validity of a single clause in one of ANZ’s credit card contracts with its customer, Paciocco. This clause required Paciocco to pay a fee of $20 (the fee was $35 prior to December 2009) if he was late making his payments on his credit card. The High Court of Australia concluded that the clause was not a penalty. Nettle J dissented, based on a different view of the test question.\(^{22}\) It was accepted that Paciocco was in breach of contract by being late in his payments, so Andrews was not directly relevant to the facts of Paciocco.

The loss that ANZ suffered as a result of Paciocco’s late payment was relevant to the Court’s conclusion that the clause was not a penalty. Experts identified three categories of costs incurred by ANZ due to the late payment. The first category encompassed “operational costs” – the costs of ensuring that the payments Paciocco was required to make were actually made. These were largely costs incurred by staff in contacting the customers. The second category of costs was ANZ’s “increase in loss provisions”. This represented the reduction in the value to ANZ of Paciocco’s debt because of the increased risk that he would default. The third category was “increase in the cost of regulatory capital”. This represented the capital that ANZ needed to keep as a “buffer” which could be used by ANZ in the event that Paciocco defaulted.\(^{23}\) The second and third categories of loss would have been too remote for ANZ to recover had they sued Paciocco for breach of contract.\(^{24}\) However, a majority of the High Court

\(^{20}\) Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [74], [77], [83]. Primary obligations are the things the parties agree to perform, while secondary obligations are the obligations that arise on breach: Arthur Corbin “Discharge of Contracts” (1913) 22 YLJ 513 at 514.

\(^{21}\) Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [181]–[185], [278]–[280], [291], [292].

\(^{22}\) See discussion below at Part III, C The bargain approach.

\(^{23}\) Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [58]–[65].

\(^{24}\) Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [171].
concluded that ANZ was nonetheless able to refer to these costs to justify the late payment fee.\textsuperscript{25}

4. Torchlight

Torchlight Ltd entered into a loan agreement with Wilaci Ltd. Wilaci was to lend Torchlight $37m, for which Torchlight was to pay $5m, plus a further $320,000 to reflect that Wilaci would be incurring interest charges to Credit Suisse, from whom it would borrow the money. The agreement provided for a late payment fee of $500,000 per week. Torchlight defaulted and sought to escape the obligation to pay the late payment fee. The principal issue on appeal was whether the late payment fee was an unenforceable penalty.\textsuperscript{26}

Muir J in the High Court of New Zealand, in a decision that is consistent with the traditional Dunlop approach\textsuperscript{27} – hardly surprising, since the decision was given prior to Cavendish and Paciocco – found that the late payment fee was penal.\textsuperscript{28} The Court of Appeal, applying Cavendish and Paciocco, reached the opposite result. The Court of Appeal framed the question whether the late payment fee was a penalty as being “whether the late payment fee is out of all proportion to any legitimate interest of Wilaci in due repayment … or, to put it another way, that the predominant purpose of the late payment fee is to punish.”\textsuperscript{29}

In determining the legitimate interest of Wilaci in repayment, the damages that Wilaci might have received had it sued on the primary obligation alone were of only limited relevance.\textsuperscript{30} Instead:\textsuperscript{31}

\begin{quote}
[T]he legitimate interests of the lender will reflect a raft of considerations, including the value of the credit they provide, in the market in which it is provided, the level of risk to the [lender] both before and after default (which are likely to differ), costs of recovery, and opportunity and reputational costs (if any). The best measure of these considerations is the worth parties of even bargaining strength place on them in the transaction in issue. Even if the value of credit provided is assumed to be unchanged, the effect of default is normally to place a premium on the legitimate cost of credit post-default because of the other factors just enumerated.
\end{quote}

In the context of this case, the Court of Appeal considered that Wilaci’s legitimate interest in the transaction could be measured by considering the total cost of credit assuming due performance. $5m plus $320,000 over 60 days is over

\textsuperscript{25} Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [66] per Kiefel J (French CJ concurring), at [176] per Gageler J, and at [283] per Keane J.
\textsuperscript{26} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [57].
\textsuperscript{27} Torchlight Fund No 1 LP (in rec) v Johnstone [2015] NZHC 2559, see especially [167].
\textsuperscript{28} The fee was “simply an impost sufficiently draconian to concentrate Torchlight’s mind on the importance of timely repayment” (at [171]). As such, it was imposed in terrorem and its predominant function was deterrence, making it a penalty (at [172]). Muir J expressed a degree of reluctance in making that finding at [172], but felt bound by the authorities.
\textsuperscript{29} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [95].
\textsuperscript{30} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [96].
\textsuperscript{31} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [98].
$88,000 per day.\textsuperscript{32} That $88,000 per day is effectively the price that Torchlight has paid for the use of Wilaci’s money; on the other side of the coin it is the daily rate of return to Wilaci for lending its money to Torchlight. That price/rate of return reflected a number of factors about the loan, including that it was a risky transaction for the lender and that Wilaci was not normally a commercial lender.\textsuperscript{33} The cost of credit can then be compared with the cost of credit post-default. A late fee of $500,000 per week is over $71,000 per day – effectively the price of Torchlight keeping Wilaci’s money after the time when it was supposed to have paid it back. As the Court of Appeal observed, a distinctive feature of the case is that the loan agreement provided a reduced cost of credit post-default. Moreover, for the purposes of the rule against penalties, the late payment fee could not be said to be out of proportion to Wilaci’s legitimate interest in the transaction and therefore was not penal.\textsuperscript{34}

C. An Inquiry into Substance

At this stage it is helpful to clarify that the inquiry into whether a clause is penal is, and always has been, a legal question concerned with substance. As the Court of Appeal put it in Torchlight, “[t]he real question is whether in substance the [clause in question] has the illegitimate qualities of an unenforceable penalty”.\textsuperscript{35} The outcome does not turn on the parties’ subjective intentions; it is not determined with reference to whether or not the parties actually intended the clause to be punitive, or a deterrent, or a genuine pre-estimate of damages in the event of breach.\textsuperscript{36} Since the penal (or non-penal) nature of a clause does not depend on the subjective intentions of the parties at the time it was drafted, clauses can be justified as non-penal post hoc. As long as the quantum of the clause in question is not extravagantly out of proportion with a legitimate interest, it does not matter that the quantum was not actually set with reference to that legitimate interest. The facts of Paciocco are illustrative: in court, ANZ identified various losses linked to late payment to justify the late payment fee, even though those losses had not actually been used to set its quantum.\textsuperscript{37}

Nor does the penal nature of a clause turn on the description of the clause as “penal” or “not penal” by one or both parties (which may not always coincide with the parties’ subjective intentions).\textsuperscript{38} It is a long standing feature of the rule that the court can look through what the parties have labelled a liquidated damages clause and conclude that it is a penalty.\textsuperscript{39} By the same token, in Torchlight the Court of Appeal observed that “[c]haracterisation by a party of a payment as a ‘penalty’ in the course of negotiations has only modest significance”.\textsuperscript{40} This

\textsuperscript{32} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [99].
\textsuperscript{33} See Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [12]–[13].
\textsuperscript{34} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [100].
\textsuperscript{35} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [100].
\textsuperscript{36} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [100].
\textsuperscript{37} Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [15].
\textsuperscript{38} See, for example, Ford Motor Co v Armstrong (1915) 31 TLR 267 (CA).
\textsuperscript{39} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [100].
\textsuperscript{40} Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [100].
means that parties cannot circumvent the rule through “ingenious drafting”, which would be possible if form prevailed over substance.

D. The Need for a New Approach in New Zealand

When a New Zealand court comes to decide a case on penalty clauses, it is unlikely to retain the traditional Dunlop approach. The most recent New Zealand Court of Appeal decision on penalties applying New Zealand law was Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd, which still focused on the fact that penalty clauses are rendered unenforceable under a “branch of equity’s relief jurisdiction”. Burrows, Finn and Todd continue to explain the distinction between liquidated damages and a penalty in terms of whether the secondary obligation is “in the nature of a threat held over the other party in terrorem”, rather than being “a genuine pre-estimate of … loss”. However, this approach has been rejected in both the United Kingdom and Australia in favour of a focus on the performance interest (as will be explained further below) and it is likely that New Zealand courts will follow suit.

The strongest signal from Torchlight that we can expect such a result is found in the Court of Appeal’s description of Dunlop (or, at least, the way Dunlop was subsequently treated) as “diverting” the development of the doctrine, leading to a subsequent “redirection” of the doctrine in Cavendish and Paciocco. A New Zealand court would be able to adopt either the United Kingdom’s approach or Australia’s approach to the engagement question; and either the party purposive approach or the bargain approach to the test question.

II. THE ENGAGEMENT QUESTION

A. The Different Approaches to the Engagement Question

The engagement question is concerned with which kinds of clauses have the potential to be penalties. Confirming that a clause engages the rule against penalties is a necessary but not sufficient requirement for a court finding that the clause is penal: the court must then go on and consider whether the clause is penal by applying the test, the substance of which is discussed in the next part of this paper.

A penalty clause can be said to have two parts: a triggering event, and a resulting detriment imposed when the trigger condition occurs. To engage the rule against penalties, a clause must impose some kind of detriment on the breaching party. The detriment does not have to be an obligation to pay money to the innocent party, for example the innocent party could withhold payments that would otherwise be due to the breaching party. Cavendish and Andrews appear to differ on what kinds of triggering events will cause a clause to engage

---

42 Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd [2004] 2 NZLR 614 (CA) at [56].
44 Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293, see headings to [74] and [79].
the rule. The United Kingdom’s approach is the traditional one, maintaining the
approach adopted in the earliest days of the rule against penalties: only clauses
that are triggered by a breach of contract will engage the penalty rule. This is
the approach that New Zealand courts will almost certainly adopt. In contrast,
on the Australian approach, a clause need not be triggered by breach of contract
to engage the rule. After explaining each approach we will compare the two, and
conclude that, although on the face of it the two jurisdictions adopt contradictory
stances,46 in practice there will probably be little difference in the application of
each test.

The strongest piece of evidence we have that New Zealand courts are more
likely to follow the Cavendish approach to the engagement question is that that
is exactly what happened in Torchlight, despite the relevant law being that of
New South Wales! Kós P stated that the essential question regarding engagement
of the rule against penalties was:47

whether the late payment fee is a primary obligation — that is, a payment for
further funding accommodation — or a secondary obligation conditional on, and
responsive to, default.

This formulation of the test for the engagement question is consistent with
the Cavendish approach, under which the penalty rule is only engaged by clauses
that are triggered by breach of contract;48 that is, a failure to do something that
the breaching party promised to do, whether or not the words “I promise” are
actually used.

In contrast, on the Australian approach, a clause need not be triggered by
a breach of contract to engage the rule against penalties. The High Court of
Australia stated that:49

In general terms, a stipulation prima facie imposes a penalty on a party (‘the first
party’) if, as a matter of substance, it is collateral (or accessory) to a primary
stipulation in favour of a second party and this collateral stipulation, upon the
failure of the primary stipulation, imposes upon the first party an additional
detriment, the penalty, to benefit the second party. In that sense, the collateral or
accessory stipulation is described as being in the nature of a security for and in
terrorem of the satisfaction of the primary stipulation.

This test is somewhat convoluted, so we will explain it in some detail.
The first part of the test refers to primary and collateral “stipulations”. Here,
“stipulation” is another way of saying “contractual term” and encompasses
contractual terms in general rather than only those that contain promises. This

46 The approach in Andrews v Australia and New Zealand Banking Group Ltd [2012] HCA 30,
(2012) 247 CLR 205 was rejected in Cavendish Square Holding BV v Makdessi [2015] UKSC
67, [2015] 3 WLR 1373 at [42]. Cavendish was rejected in turn in Paciocco v Australia and
New Zealand Banking Group Ltd [2016] HCA 28, at [121]-[123].
47 Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [42].
48 Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [41]-[42].
at [10]. The text above is followed by the following sentences: “If compensation can be made
to the second party for the prejudice suffered by failure of the primary stipulation, the collateral
stipulation and the penalty are enforced only to the extent of that compensation. The first party is
relieved to that degree from liability to satisfy the collateral stipulation.” We read this part of the
paragraph as providing a broad outline of how the rule against penalties works when a clause is
penal, as opposed to adding anything to the question of when the rule is engaged.
allows the rule against penalties to apply to clauses that are not triggered by breach of contract. In particular, it extends to what we will call “alternative stipulations”, where a party agrees to perform one of two alternatives, but has not failed to do something that they promised simply by failing to perform one. *Andrews* was a case that featured paired alternative stipulations.

The Australian test introduces the idea that some paired alternative stipulations will feature one “primary” stipulation and another which is “accessory” or “collateral” to the primary stipulation. This will only be the case for some paired alternative stipulations. For example, a promise to deliver either a green or a blue version of a car would normally be understood as putting forward true equal alternatives rather than a primary stipulation and an accessory one. Clauses that offer true equal alternatives do not engage the rule.

The Court provided no express guidance on how to determine which stipulation is primary. Since the collateral stipulation functions as “security” for the primary stipulation, it follows that the primary stipulation is the real objective that the innocent party is trying to achieve, while the collateral stipulation ensures that purpose is achieved, or functions as a second-best-alternative substitute. That is, the collateral stipulation is not what the innocent party is really trying to achieve or hoping will occur. In the context of the banking charges referred to in *Andrews*, one might think the objective purpose of the paired stipulations is to prevent the customer from taking their account into overdraft. Thus, the stipulation requiring the customer to keep their account in credit will be the primary stipulation. The overdraft fee is therefore the collateral stipulation.

It seems, then, that determining whether paired stipulations are primary and secondary as opposed to true alternatives, and, if so, which is the primary stipulation, is a question of construction. Of course, the parties’ own labelling of one stipulation as primary will not be determinative.

The next part of the *Andrews* test is satisfied if, on the failure of the primary stipulation, the collateral stipulation confers an “additional detriment” on the first party (the breaching party) to the benefit of the second party (the innocent party). This raises the question “additional to what?” The most sensible answer is: “additional to the detriment that would normally follow from a failure of the primary stipulation”. This part of the test involves an evaluative exercise as it requires comparison between the detriment following from the failure of the primary stipulation and the detriment imposed by the collateral stipulation.

---

50 In the context of breach of contract, it will be clear that the primary stipulation is the promise, and the collateral stipulation is the fee payable on breach.


52 See *Waterside Workers’ Federation of Australia v Stewart* (1919) 27 CLR 119 (HCA). In that case, the Workers’ Federation executed a bond where one stipulation required them to pay £500 to the employer, and the alternative stipulation required them to pay £50 on every occasion that its member workers went on strike. It seems the court might conclude the purpose of the bond was to require the Workers’ Federation to pay £50 if the workers went on strike – the alternative undertaking to pay £500 seems to have been designed to ensure the Federation actually did pay out the £50. However, the agreement was framed as if the debt of £500 was the primary stipulation. This was the normal way in which penal bonds were structured (see Samuel Williston *A Treatise on the Law of Contracts* (4th ed, Lawyers Cooperative, Rochester (NY), 2000) at §42:15). See also *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28 at [243].
The requirement for an “additional detriment” prevents the rule against penalties from being engaged by exclusion or limitation clauses, which are agreed remedies clauses that provide that the breaching party’s liability is less than that which would normally follow failure of the primary stipulation. This reflects modern courts’ acceptance of exclusion and limitation clauses as a normal and acceptable part of contracting.\textsuperscript{53}

B. Comparing the Approaches

In comparing the two approaches to the engagement question, the first point worth noting is that the Australian approach goes further in terms of what the court must consider. Simply that a clause is triggered by a breach of contract is enough, on the \textit{Cavendish} approach, to engage the rule against penalties. The \textit{Andrews} approach, if taken seriously, requires a court to go further and consider whether the clause imposes an additional detriment, which requires consideration of the losses suffered on failure of the primary obligation. That consideration under the \textit{Cavendish} approach falls under the test question.

Putting this difference to one side, at first glance it seems that the Australian approach can capture a class of clauses which would fall outside the United Kingdom’s approach. This is because on the Australian approach the clause need not be triggered by breach of contract to engage the rule. In our view, the same clauses will engage both rules. In \textit{Cavendish}, the Supreme Court of the United Kingdom concluded that paired alternate stipulations cannot engage the rule against penalties.\textsuperscript{54} However, the Supreme Court provided a qualification to the idea that paired stipulations can never engage the rule, which is that the rule is concerned with substance rather than form and is not defeated by clever drafting.\textsuperscript{55} Therefore, the United Kingdom’s approach can apply to clauses that are \textit{labelled} alternative stipulations by the parties, so long as in truth they represent a promise and a secondary obligation that applies on breach. On the Australian approach the rule will only be engaged by secondary obligations that are triggered by the breach of a promise.

On the Australian test, the primary stipulation represents a purpose of the contract, and the collateral stipulation is included to ensure the purpose is carried out. In the \textit{Andrews} banking contract, the purpose of the clauses is to require the customer to keep the account in credit. Concluding that one contractual stipulation is primary and the other exists to ensure it is satisfied is no different to concluding that one stipulation is a promise and the other is a liability triggered by breach. The Supreme Court of the United Kingdom decided not to adopt the \textit{Andrews} test, in part because it considered that doing so would stray too close to interfering with the parties’ primary obligations.\textsuperscript{56} However, the primary/secondary structure built into the Australian approach addresses that same concern. Lords Neuberger and Sumption wrote that the “analysis [in \textit{Andrews}] assumes that the ‘primary stipulation’ is some kind of

\begin{itemize}
\item \textsuperscript{54} \textit{Cavendish Square Holding BV v Makdessi} [2015] UKSC 67, [2015] 3 WLR 1373 at [14] and see [40].
\item \textsuperscript{55} See discussion above at Part I, C Inquiry into substance.
\item \textsuperscript{56} \textit{Cavendish Square Holding BV v Makdessi} [2015] UKSC 67, [2015] 3 WLR 1373 at [42].
\end{itemize}
promise, in which case its failure is necessarily a breach of that promise”\(^5\). Similarly, Corbin explains that a primary stipulation in the context of the bond cases has “come to be regarded as a promise that the condition will be performed”\(^5\). Just as the courts can look beyond the language that the parties have used, we can look beyond the language that the courts use and conclude that, in substance, they are concerned with the same thing. Thus, the only practical difference between the approaches will be that the clause must on the Australian test impose an “additional detriment”.

For this reason, in our view, New Zealand courts are more likely to follow the United Kingdom’s approach to the engagement question than the Australian approach. The United Kingdom’s approach is clearer, easier to understand, and is the approach that has traditionally applied to clauses that are challenged as penalties. It is for these same reasons that we prefer it to the Australian approach. Leaving to one side the evaluative element of the Australian approach, both tests will operate to exclude the same clauses. In the absence of a material difference between the approaches, the test which is easiest to understand and apply should be adopted, as this will make it clearer to commercial parties in which circumstances the rule will be engaged. The United Kingdom’s test is by far the clearer of the two\(^5\). Furthermore, the United Kingdom’s approach makes it immediately apparent that the test will only respond to secondary obligations. This is not at all clear on the Australian approach.

III. THE TEST QUESTION

A. Introduction

Having concluded that the penalty rule is engaged by a particular clause, the court must go on to consider whether or not the clause in question is actually penal. This Part considers the test for that question, and the two options that emerge. Cavendish and Paciocco both rejected the traditional Dunlop


\(^6\) Arthur Corbin Corbin on Contracts (West Publishing Co, St Paul, 1964) vol 6 at 1056. Waterside Workers’ Federation of Australia v Stewart (1919) 27 CLR 119 (HCA) is an example.

\(^5\) In fact, we consider it could be stated even more clearly; see the conclusion to this paper.
dichotomy. Instead, both decisions put forward a new approach, involving two considerations:

- What is the innocent party’s legitimate interest in performance in the primary obligation?; and
- Is the consequence of triggering the clause for the breaching party so extravagantly out of proportion with that interest that it must be seen as punitive and therefore a penalty?

Neither court gives much guidance on how far out of proportion a secondary obligation must be with the legitimate interest in performance before it becomes a penalty, especially considering that neither Cavendish nor Paciocco provide a positive example of a penalty clause. What is clear from both Cavendish and Paciocco is that the threshold is a high one.

The points of controversy and uncertainty over the test question are mostly concerned with exactly how to go about identifying (and placing a value on) the innocent party’s “legitimate interest in performance”. Two competing approaches emerge from the cases. The majority of judges in both Cavendish and Paciocco adopt what we refer to as the “party purposive approach”, while Nettle J’s dissent in Paciocco puts forward what we will refer to as the “bargain approach”.

We will introduce the idea of the “performance interest” in general terms that apply to both approaches before setting out and contrasting the bargain and party purposive approaches, and the way we argue that New Zealand should respond. The bargain approach and the party purposive approach diverge on two connected aspects to determining the innocent party’s interest in performance: when the innocent party has an interest in the consequences of performance; and the extent to which the judicial remedies available are an important reference point to the

---


61 Broadly speaking, these same two considerations can be found in all the judgments in Cavendish and Paciocco. Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [32], at [152] per Lord Mance, at [255] per Lord Hodge. Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [29] per Kiefel J (with whom French CJ agreed), at [270] per Keane J who applies Lord Hodge’s test from Cavendish, and Nettle J at [319]–[321]. Gageler J’s test is worth remarking upon as it was formulated somewhat differently. Gageler J focused on whether the exclusive purpose of the clause was to punish (158)). We agree with Köss P’s observation in Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [88] that Gageler J’s approach is “not so far removed” from the majority, considering that at [164] Gageler J stated that: “The relevant indicator of punishment lies in the negative incentive to perform being so far out of proportion with the positive interest in performance that the negative incentive amounts to deterrence by threat of punishment.” That is, that the only purpose of the clause is punishment is a conclusion reached from working through the two considerations, not a stand-alone requirement or determination that must be made before a clause can be found to be penal.

62 As the decisions do, we will use “interest in performance” and “performance interest” interchangeably.

63 Although Nettle J did dissent, see discussion below at Part III, C The bargain approach.

64 “Extravagant, exorbitant or unconscionable” per Lord Mance in Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [152], see also the judgments of Lords Hodge and Toulson at [255] and [293]. As Lord Hodge put it at [266], “the criterion of exorbitance or unconscionableness should prevent the enforcement of only egregious contractual provisions”. See also Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [87].
inquiry. The bargain approach focuses on interests that are protected in the parties’ bargain, while the party purposive approach focuses on the subjective interests of the innocent party. We prefer the bargain approach. As we will conclude, the party purposive approach allows the innocent party retrospectively to gain interests that they did not bargain for, which is not consistent with contract law as a whole.

After explaining which approach we consider New Zealand should adopt, we will explain why, in our view, New Zealand courts are likely to adopt the party purposive approach to the test question, rather than the bargain approach. It has overwhelming judicial support across *Cavendish* and *Paciocco* and, furthermore, is consistent with the courts’ approaches to determining the performance interest in the context of damages. Finally, we will address exactly what it means that the innocent party’s interest in performance must be “legitimate”, which is a requirement of both approaches.

**B. The Performance Interest**

The phrase “the performance interest” was first coined by Daniel Friedman in 1995. Friedman argued that the law of contractual remedies should take as its foundational principle that contracts are made to be performed. Accordingly, remedies for breach should be aimed at granting the innocent party performance or a substitute.

In the present context, we suggest that it can be helpful to think of the performance interest as being a kind of bundle of different interests, all of which can be described as interests that the innocent party has acquired as a result of contract formation. The values of these interests can be used as reference points and compared to the fee imposed by a purported penalty clause when determining whether it is penal.

First and foremost, the performance interest includes an interest in performance of the primary obligations under the contract. For example, in a construction contract the customer will have an interest in timely completion, as well as an interest in the actual construction itself, if the builder promised timely completion.

Second, the performance interest can encompass the consequences of performance. That is, the innocent party can be said to acquire, by contracting, interests in accruing benefits that would follow performance and interests in avoiding disbenefits that performance prevents. For example, a party may have bargained for performance by a particular date because they expected to sell for a profit, or so as to avoid breaching a contract themselves and incurring liability. Because the performance interest can look beyond the obligations specified in the contract to the consequences of performance, it can be seen as providing a measure of protection for the innocent party’s objectives or motives for contracting. As we will discuss further below, there is room for disagreement as to exactly when the performance interest extends to the

---

67 As will be explained further below, the cases diverge on the extent to which the innocent party will have an interest in the consequences of performance.
68 This is a point of difference between the bargain and party purposive approaches and is also part of a broader conflict, see “Broader conflict” below at Part III, E.
consequences of performance, and the extent to which the innocent party’s objectives or motives are relevant.

Third, the performance interest can encompass substitutes for performance, since, upon contract formation the parties can be said to acquire an interest in performance or some appropriate alternative to performance. The interest in a substitute for performance is acquired at the time of contract formation, but is conditional on breach. The extent and quantum of the performance interest generated by a contract can therefore be considered in terms of substitutes for performance as opposed to performance. What qualifies as an alternative to performance can be informed by, but is not necessarily limited to, the remedies that a court can award. This is because damages awards are (usually) how the law gives the innocent party a substitute for performance, although “[t]he availability of remedies for a breach of duty is not simply a question of providing a financial substitute for performance … it engages broader social and economic considerations”.

An interest in a substitute for performance can also extend to a substitute for the consequences that should have followed performance. For example, the law of contractual remedies allows parties in certain circumstances to recover losses consequential on breach. However, it is conceivable that an innocent party may have an interest in a consequence of performance but no interest in a substitute for that consequence in the event of breach because there is no suitable substitute. For example, it could be said that ParkingEye acquired an interest in the regular freeing up of spaces that is the consequence of car park users vacating their spots in time as promised. However, the acquisition of that interest does not necessarily mean that ParkingEye acquires an interest in a substitute for performance. Because the failure to achieve the consequence resulted in no loss, there was arguably no suitable substitute for performance. However, the absence of an interest in a substitute for car park circulation does not rule out ParkingEye using an overstay fee to deter breach, because an interest in the consequence in question, not an interest in a substitute, can justify the overstay fee.

C. The Bargain Approach

The bargain approach was adopted by Nettle J in *Paciocco*. The essence of the bargain approach is that, out of the set of interests that could conceivably be described as part of the performance interest, only those interests that are properly understood as being interests that are protected by the parties’ bargain are legitimate interests in performance that could justify a purported penalty. There are two ways in which an interest can be protected by a contract, on this view. The first is that, on an objective construction of the contract, the breaching party has taken responsibility for providing the interest. That will usually be where the interest is one in performance of a primary obligation, for example timely completion of a building job, but will also include cases where, as a matter of construction, the breaching party has taken responsibility for certain consequences of performance, for example, compensating a homeowner for

---

69 *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 at [32].
70 *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, [2015] 3 WLR 1373 at [29].
71 That is, interests in the performance of the primary obligations, interests in the consequences of performance, and interests in substitutes for performance.
72 *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28 at [331].
lost rent as a result of late completion. The second is that the interest is one for which a court is likely to award damages.

An interest will often be protected in both senses. For example, a builder who has been promised payment by a customer has that interest protected in the sense that they have an interest in the performance of payment and also in the sense that a court is likely to award damages if payment does not occur. As a result, the bargain approach takes the position that the damages that a court might award for breach of a promise will normally reflect the value of the interest that the innocent party has in performance. Accordingly, as a general rule, if a fee on breach is grossly disproportionate to the damages that the court might award, it will be a penalty.73

However, there will be some cases where the breaching party fails to provide an interest it was required to provide under the contract but this is unlikely to result in an award of damages, because it is not accompanied by a material loss or there is a material loss but it is difficult to quantify. These sorts of cases require an exception to the general rule.74 In exceptional cases where the contract protects an interest in performance broader than what can easily be translated into an award of damages, the parties can set a value themselves to incentivise or substitute for performance, as long as the value that they agree upon is not extortionate.75 Nettle J gives ParkingEye, Dunlop and Clydebank76 as examples. With respect to ParkingEye, Nettle J concluded that it was an “agreed fact” that the purpose of the parking overstay fee was to allow other members of the public to have a chance at using the parking spaces.77 That is, ParkingEye acquired an interest in keeping spaces available for other customers under the contract. Accordingly, even though the interest was not accompanied by a material loss, ParkingEye could use an overstay fee as a deterrent to try and achieve the interest that they had bargained for. Dunlop and Clydebank are explained as cases where the innocent party acquired an interest that did coincide with some material loss, but not one that was easy to quantify. Accordingly, the parties could agree on a value.

Nettle J’s approach to the facts of Paciocco is illustrative of the bargain approach in operation. ANZ sought to justify its late payment fee as reflecting several categories of loss.78 The customer had not agreed to protect ANZ from these losses under the contract. Only one of those categories would have been recoverable as damages for breach of contract, as the others were too remote.79 Accordingly, that loss was the only one protected by the contract and the only loss that could properly be regarded as part of ANZ’s performance interest. The remote losses were ones that ANZ could be said to have an interest in avoiding, but that interest was not part of the bundle of interests that ANZ effectively purchased under the contract. On Nettle J’s view of the evidence, the damages recoverable by the bank due to the late payment would have been $6.90. His

---

73 Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [331], [333].
74 Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [331], [333].
75 Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [324].
76 Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda [1905] AC 6 (HL). Clydebank was concerned with what losses could be said to have resulted from a delay in constructing warships for Spain.
77 Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [325].
78 See Part I, B The recent cases, above, for the full facts.
79 Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28 at [171].
Honour considered that the $20 late payment fee was “grossly disproportionate” to this figure and therefore a penalty.\(^80\)

We consider that the bargain approach is pragmatic in the way that it compares the innocent party’s interest in performance to the damages they would be awarded on breach. This approach is also consistent with contract law as a whole, because it focuses on interests that are communicated to the other party, are objectively apparent, and as such form part of the parties’ bargain. The parties can be said to have bargained for these interests, and they are entitled to protect them. Contract law is usually concerned with enforcing terms which are the subject of mutual agreement. Consistently with this, interests that are not part of the parties’ bargain cannot be referred to in order to justify a purported penalty on this approach.

\(D. \text{ The Party Purposive Approach}\)

The interests that the party purposive approach is concerned with are not limited to those that are protected under the contract. This means that a purported penalty can be justified with reference to an interest that is neither one for which the breaching party took responsibility under the contract nor one that is likely to give rise to a damages award. Accordingly, whatever damages might be awarded had the innocent party sued on the primary obligation alone is of only limited relevance.\(^81\)

We consider that this is not a good fit with contract law principles in general.

The majority approaches in both \textit{Paciocco} and \textit{Cavendish} are illustrative of the focus on the innocent party’s purposes and interests. In \textit{Paciocco}, the majority were concerned with “interests” in the sense of things that ANZ was interested in, rather than focusing on things that ANZ was interested in that they had protected under the contract. Keane J was most explicit about spelling out what ANZ’s interests were. His Honour decided that ANZ had an interest in making a profit, and concluded that the fact that a provision achieves a profit for the innocent party at the expense of the breaching party will not make that clause penal.\(^82\) His Honour explained that the bank could operate more profitably if customers paid on time, both because it could reinvest the funds which would otherwise have been paid late, and could reduce the cost of its services to all customers, and thereby secure more customers and higher revenues.\(^83\) Further, his Honour concluded that the bank was entitled to a “reward” for the risk it took on in granting the loans.\(^84\) These reasons justified ANZ charging a fee for late payment, and the justification did not turn on those interests being protected under the contract. The other judges in \textit{Paciocco} also referred to ANZ’s interests, but were less explicit in identifying exactly what its interests were.\(^85\)

\(^{80}\) \textit{Paciocco v Australia and New Zealand Banking Group Ltd} [2016] HCA 28 [321]–[322].

\(^{81}\) \textit{Wilaci Pty Ltd v Torchlight Fund No 1 LP} [2017] NZCA 152, [2017] 3 NZLR 293 at [96].

\(^{82}\) \textit{Paciocco v Australia and New Zealand Banking Group Ltd} [2016] HCA 28 at [221].

\(^{83}\) \textit{Paciocco v Australia and New Zealand Banking Group Ltd} [2016] HCA 28 at [278].

\(^{84}\) \textit{Paciocco v Australia and New Zealand Banking Group Ltd} [2016] HCA 28 at [66] per Kiefel J, at [176] per Gageler J.
also concluded that the clause could be justified with reference to losses which would be too remote to recover in an action for breach of contract.\textsuperscript{86}

The same focus is evident in \textit{ParkingEye}. The Supreme Court of the United Kingdom referred to ParkingEye’s “objectives” which justified charging a late stayer fee, although these objectives were not referred to in the contract itself. The Court decided that the parking charge had two main objectives: to “manage the efficient use of the parking in the interests of the retail outlets” (by deterring “misuse”); and to provide income which would allow ParkingEye to meet its costs and make a profit.\textsuperscript{87} Because ParkingEye had a legitimate interest that extended beyond recovery of loss, and the clause was not out of proportion to that interest, the clause was not penal.\textsuperscript{88} Again, this approach looks at ParkingEye’s interests qua interests, rather than testing whether the interests were contracted for. This is in contrast to Nettle J’s view that the purpose of the clause in \textit{ParkingEye} was an “agreed fact”.\textsuperscript{89}

The party purposive approach allows the innocent party retrospectively to gain interests that they did not bargain for. It allows “adjudication of parties’ individual motivations that are not necessarily the subject of mutual agreement”, as Jessica Palmer put it.\textsuperscript{90} That is fundamentally inconsistent with how contract law ought to do things, and how contract law generally does do things. Whether a clause is penal can be seen as a question of construction.\textsuperscript{91}

But, contractual construction is concerned with determining the objective intentions of the parties,\textsuperscript{92} not the subjective intentions or motivations that one party might have

\textsuperscript{86} \textit{Paciocco v Australia and New Zealand Banking Group Ltd} [2016] HCA 28 at [66] per Kiefel J (French CJ concurring), at [176] per Gageler J, and at [283] per Keane J. We will address this in more detail below.

\textsuperscript{87} \textit{Cavendish Square Holding BV v Makdessi} [2015] UKSC 67, [2015] 3 WLR 1373 at [98].

\textsuperscript{88} \textit{Cavendish Square Holding BV v Makdessi} [2015] UKSC 67, [2015] 3 WLR 1373 at [99]–[100] per Lords Neuberger and Sumption. See also [198] per Lord Mance; and [287] per Lord Hodge. Lords Cornwath, Clarke and Toulson concurred.

\textsuperscript{89} \textit{Paciocco v Australia and New Zealand Banking Group Ltd} [2016] HCA 28 at [325].

\textsuperscript{90} Jessica Palmer “Implications of the New Rule Against Penalties” (2016) 47(2) VUWLR 305 at 324. Palmer suggests that recent developments show that the law is getting dangerously close to doing so. We say it does.

\textsuperscript{91} \textit{Cavendish Square Holding BV v Makdessi} [2015] UKSC 67, [2015] 3 WLR 1373 at [9], \textit{Wilaci Pty Ltd v Torchlight Fund No 1 LP} [2017] NZCA 152, [2017] 3 NZLR 293 at [7].

\textsuperscript{92} \textit{Firm PI I Ltd v Zurich Australian Insurance and Body Corporate 398983} [2014] NZSC 147, [2015] 1 NZLR 432 at [60], \textit{Arnold v Britton} [2015] UKSC 36, [2015] AC 1619 at [15]. Both decisions endorse Lord Hoffmann’s statement that a Court is to identify the parties’ intentions with reference to “what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean”, see \textit{Investors Compensation Scheme Ltd v West Bromwich Building Society} [1998] 1 WLR 896 (HL) at 912 and \textit{Chartbrook Ltd v Persimmon Homes Ltd} [2009] UKHL 38 [2009] 1 AC 1101 at [14].
had. Similarly, terms are implied in fact if they are necessary to make the contract work, not just because they seem reasonable or are necessary to achieve what one of the parties wanted.

E. The Primacy of the Party Purposive Approach in Light of the Broader Conflict Over the Performance Interest

Although we consider the party purposive approach is a poor fit with contract law in general, we suggest it is more likely to be adopted in New Zealand than the bargain approach.

The Court of Appeal gave no express indication as to the desirability of adopting the Australian approach in New Zealand, although, in giving the judgment of the Court, Kós P referred to Paciocco as giving “a significantly greater measure of clarity to the doctrine of penalties in Australia”, and was readily able to apply the party purposive approach to the facts of the case. The fact that the party purposive approach was adopted by all but one of the judges across the recent cases we have considered is a strong indication that New Zealand is likely to adopt it.

Furthermore, the party purposive approach conforms with a trend that has developed in a broader conflict over the scope of the performance interest in contract law. We will examine that broader conflict now.

As Palmer put it, the performance interest has “been explicitly recognised and incorporated into the law on contractual damages”. In the context of damages, the performance interest is most frequently referred to when the court decides whether to award the “diminution in value” or “cost of cure” measure following a breach of contract. Diminution in value reflects the difference between the value of the performance that has been completed and the value of the performance that was promised. Cost to cure reflects the cost of remedying the defective performance.

The leading New Zealand case on the issue, Altimarloch, illustrates the broader conflict between two competing approaches to determining the performance interest. That case concerned the sale of a property which the purchaser intended to use for growing grapes. The vendor made a misrepresentation about the water rights that came with the property: the property actually came...
with much less access to water than the vendor promised. To provide the missing water rights the majority held that additional rights would have to be bought from neighbouring properties and a dam would need to be built. This meant the cost of cure was over $1m. In contrast, the diminution in value was $125,000; the property would have been worth $2.675m with the water rights, but was only worth $2.55m without them.98

The majority in the Supreme Court awarded the cost to cure, rather than the diminution in value, in large part because their analysis of the performance interest focused on the purchaser’s motives for buying the property. McGrath J noted that “[t]he importance to the purchaser of the representations as to the extent of the water rights arose from its intention to develop a vineyard on the land”.99 On this view of the performance interest, an award which compensated the plaintiff for the diminution in value would be insufficient to put him in the position he would have been in had the contract been performed – it would not have allowed him to acquire the necessary water to grow grapes. Clearly, the innocent party’s motive in entering the contract was relevant to the Court’s determination that diminution in value was not the appropriate damages measure, even though that motive was not specified in the contract. Therefore, the majority’s concept of the performance interest takes into account similar considerations to the party purposive approach.100

In contrast, Elias CJ’s approach in Altimarloch is consistent with the bargain approach. Her Honour adopted a narrower approach to calculating the performance interest, which led her to prefer the diminution in value measure.101 Her Honour concluded that the purchaser’s performance interest was merely the right to receive a property of a certain value, writing:102

the contract in the present case was one for the purchase of land, in respect of which a market existed and value could be objectively assessed to reflect the breach of warranty… The construction of a storage dam for water in the present case is not stipulated performance under the contract.

The Chief Justice’s approach is consistent with Nettle J’s judgment because her Honour focused on the wording of the contract itself, and did not consider the innocent party’s broader motives and interests. Her Honour held that because the purchaser had not stipulated for construction of a dam in the contract, awarding the cost of building a dam would not produce conformity with the contract.103 The Chief Justice also held that it would be unreasonable to award the cost of

100 See also Tabcorp Holdings Ltd v Bowen Investments Pty Ltd (2009) 236 CLR 272 (HCA) and Clark v Macourt (2013) 304 ALR 220 (HCA) for two further examples of the same sort of reasoning used to justify a cost of cure award.
cure. Unlike the majority, Elias CJ did not attach any weight to the fact that the purchaser intended to use the property to grow grapes, as this was not specified in the contract.

**F. Legitimacy**

“Legitimacy” is a common requirement of both the bargain approach and the party purposive approach – it will be a feature of the New Zealand test regardless of which approach the courts adopt. However, none of the recent cases give much express guidance on what the “legitimacy” requirement actually means. One possibility is that the requirement that the interest be legitimate is a “nebulous exception”, which allows the court to reserve the right to strike out a clause as “illegitimate”, but where the reasons for doing so are apparent to the court alone. We will discount that possibility, and search for a more satisfactory one. Given the case law, some interests are clearly not illegitimate. These include deterring breach, making a profit and, given that making a profit is not illegitimate, perhaps even betterment. Clearly, punishment for breach is illegitimate, but it is unclear precisely what (if anything) the requirement means beyond that.

It might be tempting to explain the requirement for a “legitimate interest in performance” as meaning that the innocent party must have a good reason to prefer performance to the normal consequences of non-performance, which are that they can sue the breaching party for damages. So, in ParkingEye, the innocent party has a good reason to prefer performance to damages because they had suffered no material loss and would receive nothing in damages. Accordingly, the innocent party can legitimately set a non-extortionate fee for breach to try and secure performance. However, that cannot be a satisfactory explanation for the requirement of legitimacy. First, we have effectively substituted the requirement of legitimacy for one of a “good reason”, without explaining what makes a reason “good”. Furthermore, while it might be apt for cases like ParkingEye, this account of legitimacy is too narrow because not all clauses that might engage the

---


109 Although Francis Dawson argued betterment would make an interest illegitimate, in “Determining Penalties as a Matter of Construction” (2016) LMCLQ 207 at 213, this would seem to be inconsistent with the result in Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28.

110 See, for example, Cavendish Square Holding BV v Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 at [28].
rule against penalties are best understood as seeking to secure performance. In some cases, the innocent party might be equally happy to receive performance or the substitute sum provided in a secondary stipulation. For example, a classic liquidated damages clause exists not to deter breach but because the parties have agreed to fix in advance the sum payable in case of breach. If there is a dispute over whether a clause described as a liquidated damages clause is penal, it would not be helpful to consider whether the innocent party would have preferred performance. Rather, the focus should be on the value of performance, which can then be compared to the quantum of the purported liquidated damages clause, and potentially what damages might be available.

In Cavendish, there is some suggestion that the parties’ relative bargaining strength may be relevant to determining the legitimacy of an interest. Lord Neuberger and Lord Sumption stated that:

In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.

On the other hand, Lord Mance seemed to suggest that inequality of bargaining power was a factor in determining extravagance, not legitimacy. As Palmer observed, discussion of bargaining power is strangely absent in Paciocco, despite the case being about a standard form consumer banking contract.

Palmer argued “[l]egitimate interests are only those in relation to which a court would be likely to grant relief”. This means that the rule against penalties should knock out as illegitimate a clause requiring disgorgement of profits where the facts are not sufficiently close to Attorney-General v Blake, or a clause in the Ruxley Electronics contract requiring the builder to pay the customer a sum equal to the cost of cure in the event of non-compliance with the specified depth.

Palmer’s anchoring of legitimacy to judicial remedies can be reconciled with the bargain approach, upon which the remedies available from the courts are a useful comparison when determining the legitimacy of an interest. The available judicial remedies are a useful comparison, rather than being determinative, because some aspects of the law of contractual remedies can be understood as providing default rules for what the parties intended, from which reasonable parties might depart. Where that is the case, it is legitimate for parties to agree to provide a greater remedy than the default one, just as parties can agree to limit or exclude the liability that would normally be available. The only

113 Jessica Palmer “Implications of the New Rule Against Penalties” (2016) 47(2) VUWLR 305 at 325.
114 Jessica Palmer “Implications of the New Rule Against Penalties” (2016) 47(2) VUWLR 305 at 324. This follows from Palmer’s position that the rationale for the rule against penalties is that parties cannot agree to remedies that a court does not have the power to grant.
115 Attorney-General v Blake [2000] UKHL 45. This example is from Jessica Palmer “Implications of the New Rule Against Penalties” (2016) 47(2) VUWLR 305.
117 See Jessica Palmer “Implications of the New Rule Against Penalties” (2016) 47(2) VUWLR 305 at 324: “Terms stipulating remedies must continue to be compared to the remedies that would be available from the courts to test whether they are penal or not.”
New Variations on the Rule Against Penalties

qualifier is that they do not go overboard in terms of quantum, which would be to move beyond a compensatory purpose. We have already discussed this principle in the context of interests that result in no material loss or a loss that is difficult to quantify.\(^\text{118}\) However, aspects of the law of contractual remedies that are best understood as limiting recoverable damages to those that are just and proportionate\(^\text{119}\) should be seen as placing hard limits on legitimacy. There is, of course, room to argue over which parts of the law of contractual remedies provide default rules and which provide hard limits.\(^\text{120}\)

However, Palmer’s approach is not easy to reconcile with the party purposive approach of Cavendish and Paciocco. As Kós P put it in Torchlight, following those decisions, the question of “what damages [the innocent party] might have received had it sued on the primary obligation alone … has only limited relevance”.\(^\text{121}\) In our view, the requirement of legitimacy serves as an important control for the party purposive approach. Under the party purposive approach, the interests that a party can use to justify a purported penalty are not limited to ones that the breaching party has objectively agreed to protect. Neither are they limited to interests that the innocent party actually had in mind at the time of contract formation.\(^\text{122}\) Therefore, on the party purposive approach, there is a need for a control mechanism so that the innocent party cannot rely on any interest, no matter how idiosyncratic or contrary to public policy.\(^\text{123}\)

We suggest that the notion of a legitimate interest in performance probably encompasses that the interest must both be reasonable and have some reasonable connection to the primary obligation in question.\(^\text{124}\) In this sense, the “reasonableness” of an interest or its connection to the primary obligation is assessed by considering whether a reasonable third party would accept that that interest is one that the innocent party could reasonably have had, regardless of whether or not it was actually protected in the bargain. So, we would suggest, it would be illegitimate for an airline to use excess baggage fees as a vehicle for raising funds for developing an intercity bus programme. The main reason for the illegitimacy here is not that an airline developing a bus service is unthinkable, but that there is no reasonable connection between the fact that the customer’s baggage is heavier than the allowance and the airline’s desire to launch a bus programme. In contrast, a reasonable person might expect that the purchaser of a rural property with significant water rights might want to use it to grow grapes, and that that objective would be thwarted by a failure to provide the promised water rights. And, there is a reasonable connection between a bank receiving payment on time and its ability to reinvest that money, and between a car park overstay fee and an interest in freeing up car park spaces.

\(^{118}\) See the discussion above at Part III, C The bargain approach.


\(^{121}\) Wilaci Pty Ltd v Torchlight Fund No 1 LP [2017] NZCA 152, [2017] 3 NZLR 293 at [96].

\(^{122}\) See discussion above at Part I, C An inquiry into substance.

\(^{123}\) See Jessica Palmer “Implications of the New Rule Against Penalties” (2016) 47(2) VUWLR 305 at 323.

\(^{124}\) We say “some reasonable connection” to cast the net wider than reasonable foreseeability in the sense of Hadley v Baxendale (1854) 9 Exch 341.
Turning to the requirement that the interest itself be reasonable it is not easy to pinpoint an interest that the innocent party might have that would be inherently unreasonable (and accordingly illegitimate), even if it was connected to the breach. That is, the innocent party’s motive for the primary obligation would have to be unreasonable such that the plaintiff has a legitimate interest in performance of the primary obligation but not the fulfilment of their motive. Perhaps the customer in *Ruxley Electronics*,\(^{125}\) who wanted a pool constructed to a specific depth for idiosyncratic reasons (rather than any reason intelligible to a reasonable person such as that the pool be deep enough to swim or dive in), is an example.

Where this leaves us on the question of legitimacy is that there is no one clear identifiable requirement added by the need to identify a “legitimate” interest in performance. We suggest that it invites consideration of the link between the breach and the agreed remedy, and the inherent reasonableness of the interest in question. The latter may simply serve as a control to prevent parties from pursuing interests that are clearly contrary to public policy.

**IV. CONCLUSION**

In this paper, we have discussed the options for New Zealand that arise from three recent decisions on the rule against penalties, and which mark a significant change in the courts’ approach to the rule. In terms of the engagement question, while the United Kingdom and Australia appear to adopt contradictory stances, in actual fact their approaches will usually capture the same clauses. The choice for New Zealand with respect to that question is easy – the *Cavendish* formulation is simpler and, in substance, is compatible with *Andrews*. We would word the test thus:

> A clause engages the rule against penalties if it is, in substance, a secondary obligation triggered by the breach of a contractual promise.

With respect to the test question, there are two approaches which differ significantly. The broader “party purposive approach” can consider the innocent party’s motives and interests for including the clause which are not protected in the contract. As long as the innocent party can identify a legitimate interest, and the secondary obligation is not disproportionate to this, the clause will not be a penalty. Further, any losses that are suffered, however remote, can be used to justify the clause. In contrast, the narrower “bargain approach” focuses only on the interests that are actually protected in the contract. The choice for New Zealand with respect to this question is more difficult – the decision is between a test that has overwhelming judicial support, and one that is a better fit for contract law.

---

\(^{125}\) *Ruxley Electronics and Construction Ltd v Forsyth* [1996] 1 AC 344 (HL).