CONFUSED IN WORDS: UNCONSCIONABILITY AND THE DOCTRINE OF PENALTIES

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This paper is concerned with the role of unconscionability in the doctrine of penalties. It argues that unconscionability, although clearly a requirement in the Australian doctrine of penalties, is an elusive concept that has given rise to much confusion. This is because of the general uncertainty of the doctrine, ambiguity in the meaning of the term 'unconscionability' and uncertainty as to whether unconscionability is a separate requirement in determining whether a liquidated damages provision is a penalty. This paper argues that if unconscionability is to continue as a requirement in judicial determination of penalties, the courts should maintain a robust and relatively narrow notion of unconscionability. This is because the very purpose of liquidated damages clauses is to avoid uncertainty and litigation and to minimise the likelihood and costs of disputes. Ironically, the continued uncertainty surrounding the concept of 'unconscionability' – and therefore the doctrine of penalties as a whole – means that liquidated damages clauses actually perpetuate, rather than avoid, these problems.

'Be not careless in deeds, nor confused in words, nor rambling in thought.'

– *Marcus Aurelius, 121 – 180CE*

I INTRODUCTION

This paper is concerned with the role of unconscionability in the doctrine of penalties. Parties to a contract are taken to have the freedom to stipulate in their agreement the consequences flowing from breach, be they the payment of an agreed sum or the transfer of property.[1] However, the right of the parties to agree to obligations arising from breach is subject to a rule of public policy. An agreed sum will not be enforced if the court is satisfied that it is not a genuine pre-estimate of loss, but is, rather, a penalty. A penalty is a means of deterring a party from, or punishing them for, a breach.[2] In such a case, the injured party cannot enforce the liquidated damages clause, but retains the right to claim damages at common law.[3]

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1 See, eg, *Forestry Commission of NSW v Stefanetto* (1976) 133 CLR 507 ('*Forestry Commission*'); *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615 ('*PC Developments*'); *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656.

2 See, eg, *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406 (Unreported, Brereton J, April 2007), [74].

3 See, eg, *Jobson v Johnson* [1989] 1 All ER 621; *Cooden Engineering Co Ltd v Stanford* [1953] 1 QB 86 ('*Cooden Engineering*'); *Bridge v Campbell Discount Co Ltd* [1962] AC 600 ('Bridge'); *Robophone Facilities Ltd v Blank* [1966] 3 All ER 128 ('*Robophone*'); *Challenge Finance Ltd v Forshaw and Another* (No 4) (1995) 217 ALR 264 ('*Challenge Finance*').

Whether an agreed damages clause is a genuine pre-estimate of loss is a question of fact,[4] to be determined by reference to the guidelines promulgated by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd.*[5] Those guidelines have been almost unanimously accepted by subsequent courts in the UK and Australia, including the High Court in its most recent pronouncement on the doctrine of penalties in *Ringrow Pty Ltd v BP Australia Pty Ltd.*[6] Principle 4(a) of Lord Dunedin's guidelines requires a court to look at whether an agreed sum is 'extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach'. In Australia, unconscionability has assumed primary importance in the assessment of whether a stipulated sum is a penalty since the leading decision of Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin.*[7]

This paper makes several claims. The first is that unconscionability is a core factor in determining whether a liquidated damages clause is valid in Australia. The second is that, as it stands, unconscionability is an elusive concept that repeatedly 'fades to grey'. This is both because of general uncertainty surrounding unconscionability and uncertainty in the meaning and application of unconscionability in the context of the doctrine of penalties. The dangers of unconscionability in this regard were highlighted some 10 years ago by Elizabeth Lanyon, in a leading article on penalties and unconscionability in Australia.[8] She observed that 'it is unsatisfactory to make general appeals to fairness or unconscionability. Modification or expansion of the penalties doctrine must be principled and based on clearly articulated policy foundations.'[9] Despite Lanyon's concerns, unconscionability has remained a key concept in the development of the doctrine of penalties in this country.

What are the implications of this uncertainty? If the doctrine of penalties is based on notions of fairness and conscience, as writers such as Hugh Collins suggest,[10] this 'fade to grey' may not be a problem, or might at least be seen to be an inherent and unavoidable aspect of the doctrine of penalties. The counter view is that the very purpose of using liquidated damages clauses is to avoid uncertainty and litigation and to minimise the likelihood and costs of disputes. These objectives, which have long been recognised by the courts, may well be undermined by the uncertainty surrounding the concept of unconscionability. In fact, given that uncertainty, liquidated damages clauses may actually generate, rather than alleviate, costs and litigation.

4 *Challenge Finance* (1995) 217 ALR 264, 280.

5 [1915] AC 79 ('*Dunlop*').

6 (2005) 224 CLR 656 ('*Ringrow*'). In that case, '[n]either side in the appeal contested the foregoing statement by Lord Dunedin of the principles governing the identification, proof and consequences of penalties in contractual stipulations. The formulation has endured for ninety years. It has been applied countless times in this and other courts': *Ringrow* (2005) 224 CLR 656, 663.

7 (1986) 162 CLR 170 ('*AMEV-UDC*').

8 Elizabeth Lanyon, 'Equity and the Doctrine of Penalties' (1996) 9 *Journal of Contract Law* 234.

9 Ibid 258.

10 Hugh Collins, *Law of Contract* (2nd ed, 1993) 346–7.

Part II of this paper explores the way in which unconscionability has contributed to the uncertainty surrounding the doctrine of penalties. Part III considers the implications of this continued uncertainty. Part IV outlines ways in which a robust and narrow view of unconscionability may alleviate the uncertainty surrounding the doctrine of penalties.

II WHY UNCONSCIONABILITY HAS CONTRIBUTED TO UNCERTAINTY IN THE DOCTRINE OF PENALTIES

This part of the paper argues that unconscionability, although clearly a requirement in the Australian doctrine of penalties, is an elusive concept that repeatedly 'fades to grey' in the relevant case law. There are a number of reasons for this phenomenon, including general uncertainty surrounding the doctrine of penalties, ambiguity in the meaning of the term 'unconscionability' (both in general and in the context of penalties) and uncertainty as to whether unconscionability is a separate requirement in determining whether a liquidated damages provision is a penalty.

A *The General Uncertainty Surrounding the Doctrine of Penalties*

The first point to be made about the use of the term 'unconscionability' in relation to the doctrine of penalties is that it was introduced into a doctrine that was already plagued by uncertainty. Writing in 1998, Goode observed that despite the plethora of available material on the doctrine, 'judges remain sharply divided as to the fundamental objective of the rule [against penalties] and the circumstances in which it may be invoked'.[11] Writing in 2006, Thompson expressed surprise at how much misunderstanding existed about liquidated damages and noted that, 'while certain principles are clear, there still exist a number of "grey areas" in the law governing this subject'.[12] Collins describes the area of law as 'perplexing'[13] and Hillman as a 'mystery',[14] while judges have described it as 'unsatisfactory',[15] 'illogical' and 'inconsistent'.[16] Carter and Peden acknowledge the 'inconsistencies' and 'complexities' in this area of the law.[17]

11 Roy Goode, 'Penalties in Finance Cases' (1988) 104 *Law Quarterly Review* 25.

12 Thomas Thompson, 'A Fresh Look at Liquidated Damages' (2006) 22 *Construction Law Journal* 289, 306.

13 Collins, above n 10, 346.

14 Robert Hillman, 'The Limits of Behavioural Decision Theory in Legal Analysis: The Case of Liquidated Damages' (1999-2000) 85 *Cornell Law Review* 717, 726.

15 *Evans v Moseley*, 84 Kan 322, 324 114P, 374, 377 (1911).

16 Ibid, as quoted in Kenneth Clarkson, Roger Miller and Timothy Muris, 'Liquidated Damages v Penalties: Sense or Nonsense' [1978] *Wisconsin Law Review* 351, 351.

17 John Carter and Elisabeth Peden, 'A Good Faith Perspective on Liquidated Damages' (2007) 23 *Journal of Contract Law* 157, 158.

One reason for this general uncertainty is that, although the ability of courts to intervene to strike down an agreed damages clause has long been acknowledged, the exact basis for that intervention is unclear. Lord Radcliffe's comment that the 'refusal to sanction legal proceedings for penalties is in fact a rule of the court's own, produced and maintained for purposes of public policy' is notorious.[18] Courts and commentators have considered the doctrine of penalties to be variously an aspect of good faith,[19] illegality,[20] a particular application of the doctrine of relief against forfeiture,[21] and an aspect of unjust enrichment.[22]

Even where a firm basis for the doctrine is acknowledged, the problems of uncertainty remain. Collins, amongst others,[23] notes the historical origins of the doctrine in the penal bond and its subsequent extension beyond loan agreements to any term of a contract where a fixed sum of compensation (or later a transfer of a property right as compensation) is set for breach. This extension was justified on two primary grounds: first, that a penalty is an unacceptable form of private punishment for breach of contract, and second, that in its attempt to pressure an individual to perform a contract, it is an unacceptable invasion of the freedom of that individual.[24] Despite these historical origins and theoretical justifications, Collins observes that the line between a valid liquidated damages clause and a penalty is never clear.[25] The general uncertainties surrounding the doctrine of penalties appear to be exacerbated by the acknowledgement of the courts that each case must turn on its own facts, such that precedent is of relatively limited value.[26] Perhaps most fundamentally, courts and commentators have been perplexed as to why courts have historically been willing to impinge upon the freedom of contract when assessing the validity of agreed damages clauses, when they are so reluctant to do so in other areas of contract.[27]

18 *Bridge* [1962] AC 600, 622 (Lord Radcliffe).

19 Carter and Peden, above n 17, 159.

20 *Challenge Finance* (1995) 217 ALR 264, 271 (Young J).

21 *Forestry Commission* (1976) 8 ALR 297, 306–7 (Mason J).

22 *PC Developments* (1991) 22 NSWLR 615, 626 (Mahoney JA), noting that the decisions of Deane and Dawson JJ in *Stern v McArthur* (1988) 165 CLR 489 established that judicial intervention required more than mere benefit to one party – that party must also take advantage of 'another's special vulnerability or misadventure for the unjust enrichment of himself'.

23 See, eg, D W Greig and J L R Davis, *Law of Contract* (1987) 1446; Hillman, above n 14, 726; *AMEV-UDC* (1986) 162 CLR 170, 186–91 (Mason and Wilson JJ); *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1, 40 (Priestley JA) and *Challenge Finance* (1995) 217 ALR 264, 271 (Young J).

24 See, eg, Collins, above n 10, 344 and Jeffrey Coopersmith, 'Refocusing Liquidated Damages Law for Real Estate Contracts: Returning to the Historical Roots of the Penalty Doctrine' (1990) 39 *Emory Law Journal* 267, 268: '[t]he rationale for non-enforcement historically was a recognition that the promisor under a penal bond or a similar contract had very little choice in the fact of "overpowering economic needs" or the "illusions of hope"'.

25 Collins, above n 10, 346. See also Lisa Miller, 'Penalty Clauses in England and France: A Comparative Study' (2004) 53 *International and Comparative Law Quarterly* 79, 82.

26 See, eg, *Bridge Wholesale Acceptance Corporation (Aus) Ltd v Rega Pty Ltd* (1992) Aust Contract R 90-037 (Giles J), noting that it was not possible simply to apply the decision in *Citicorp Australasia Ltd v Hendry* (1985) 4 NSWLR 1, despite the similarities between the respective contractual provisions in the two cases.

27 Hillman, above n 14, 719.

The guidelines promulgated by Lord Dunedin in *Dunlop* attempted to provide greater certainty in this area. They are extensively quoted in the relevant case law, but it is necessary for the purposes of the discussion to restate them here. They are:

1. Though the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages. This doctrine may be said to be found passim in nearly every case.
2. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage ...
3. The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach ...
4. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:
   a. *It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach ...*
   b. It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid ...
   c. There is a presumption (but no more) that it is penalty when a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.[28]

To some extent, this attempt to introduce greater certainty into the doctrine of penalties was successful, at least insofar as these guidelines have been widely accepted by subsequent courts. Acceptance has not led, however, to widespread agreement as to how the principles are to be applied. Principle 4(a), in particular, has proved controversial.[29]

In Australia, the emphasis on unconscionability in determining whether an agreed sum is a penalty derives primarily from the joint judgment of Mason and Wilson JJ in *AMEV-UDC*. Their Honours undertook a careful historical analysis

28 *Dunlop* [1915] AC 79, 86–7 (emphasis added).

29 Lord Parmoor in *Dunlop* also used the phrase 'extravagant or unconscionable': *Dunlop* [1915] AC 79, 101. Lord Parmoor was of the view a court should be slow to intervene in agreed sums clauses, only doing so where there is an extravagant disproportion between the agreed sum and the amount of any damage capable of pre-estimate, and there is a pre-estimate of a sum for damages where the real damage can easily be ascertained.

of the doctrine of penalties. From this, they expressed the view that equity and the common law have long maintained a supervisory jurisdiction to relieve against provisions 'which are so unconscionable or oppressive that their nature is penal rather than compensatory'.[30] They recognised two lines of authority: first, that an agreed sum would be a penalty where it is 'extravagant, exorbitant or unconscionable', as in *Clydebank Engineering and Shipbuilding Company Ltd v Don Jose Ramos Yzquierdo Y Castaneda*[31] and *Dunlop*; and second, that an agreed sum will be a penalty when it is merely greater than the amount of damages which could possibly be awarded for the relevant breach, as stated in a line of cases including *Cooden Engineering*.[32]

Urging a return to the *Dunlop* principles, Mason and Wilson JJ were of the view that the test of whether or not an agreed sum was a penalty was one of degree and depended on a number of circumstances, including the degree of disproportion between the sum and the greatest loss that could be suffered from the breach,[33] the nature of the relationship between the parties and the unconscionability (if any) in the plaintiff seeking to enforce the provision. Their view reinforced classic liberal notions of freedom of contract: 'the courts should not ... be too ready to find the requisite degree of disproportion lest they impinge on the parties' freedom to settle for themselves the rights and liabilities following a breach of contract'.[34]

Like the judgment of Lord Dunedin, the judgment of Mason and Wilson JJ can be seen as an attempt to reduce uncertainty within this area of the law. As the quotation at the beginning of this paper suggests, their Honours attempted to uphold the right of the parties to determine their contractual terms by narrowing judicial intervention to circumstances where the agreed sum was penal rather than compensatory.

Use of the term 'unconscionability' has been unfortunate in this regard, not least because of the general controversies surrounding the term in Australia, including

30 *AMEV-UDC* (1986) 162 CLR 170, 193.

31 [1905] AC 6 ('*Clydebank Engineering*').

32 [1953] 1 QB 86. See also the judgment of Meagher JA in *PC Developments* (1991) 22 NSWLR 615, 650 who also notes two lines of authority: a 'mechanical' approach based on a comparison of the agreed sum and likely damages and a 'discretionary' approach based on conscience.

33 In the US case of *Moser v Gosnell* 334 SC 425, 513 SE 2d 123 (Ct App 1999), the Court struck down an agreed sum, saying that the test was whether the stipulated sum was so large that it was plainly disproportionate to any probable damage resulting from the breach of contract. In this case, the agreed sum was US$585 000 and the parties could not have believed that any probable damage resulting from the breach would amount to this figure. This view was supported by the evidence which showed that the actual damages amounted to only a few thousand dollars.

34 *AMEV-UDC* (1986) 162 CLR 170, 193-4 (Mason and Wilson JJ).

those relating to the meaning of the term,[35] the relationship of unconscionability to the general obligation of good faith,[36] the relationship between unconscionability and unjust enrichment and the relationship between common law and statutory unconscionability provisions.[37] Debate on these issues has meant that the use of the term 'unconscionability' carries with it considerable baggage.[38] In particular, concern has been expressed that the use of terms such as 'unconscionability' and 'good faith' in the sense of a general equitable basis for judicial intervention in contracts permits the exercise of judicial discretion to an unacceptable degree.[39] As Callinan J has observed, 'courts are not armed with a general power to set aside bargains simply because in the eye of a particular judge, they might appear to be unfair, harsh or unconscionable'.[40] These concerns have been canvassed extensively elsewhere,[41] so I do not intend to review them here. They are indeed part of the difficulty associated with the use of the term 'unconscionability' in this context, but there is also much ambiguity in the specific application of the term to the doctrine of penalties.

B *The Ambiguity in the Meaning of the Term 'Unconscionability'*

In its specific application to the doctrine of penalties, unconscionability could be used to refer to at least three matters: the amount of the agreed sum (and therefore

35 In *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd* (2000) 96 FCR 491, 502, in the course of discussion about s 51AA of the *Trade Practices Act 1974* (Cth), French J observed that:

> The concept of unconscionability is arguably to be found at two levels in the unwritten law. There is a generic level which informs the fundamental principle according to which equity acts. There is the specific level at which the usage of 'unconscionability' is limited to particular categories of cases.

Of the first kind of unconscionability, Gummow and Hayne JJ in *ACCC v Berbatis Holdings Pty Ltd* (2003) 214 CLR 51, 72, observed that the term 'is used as a description of various grounds of equitable intervention to refuse enforcement of or to set aside transactions which offend equity and good conscience. The term is used across a broad range of the equity jurisdiction.' Their Honours went on to agree, however, that the term may mask rather than illuminate the underlying equitable principles at play.

36 See, eg, Nicholas Seddon and Manfred Ellinghaus, *Cheshire and Fifoot's Law of Contract* (8th ed, 2002) 7, who consider unconscionability and good faith to be different; cf Jane Stapleton, 'Good Faith in Private Law' [1999] *Current Legal Problems* 1, 7, which considers them to be synonymous.

37 *Trade Practices Act 1974* (Cth) ss 51AA, 51AB, 51AC. See further *ACCC v Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 ('*ACCC v Berbatis Holdings*'), especially the dissenting judgment of Kirby J.

38 As acknowledged by the High Court in its discussion of statutory unconscionability in *ACCC v Berbatis Holdings* (2003) 214 CLR 51.

39 Allan Farnsworth, 'Ten Questions About Good Faith and Fair Dealing in United States Contract Law' [2002] *Australian Mining and Petroleum Law Association Yearbook* 1, 14; John Carter and Elisabeth Peden, 'Good Faith in Australian Contract Law' (2003) 19 *Journal of Contract Law* 155, 171.

40 *ACCC v Berbatis Holdings* (2003) 214 CLR 51, 110.

41 See, eg, Rick Bigwood, 'Conscience and the Liberal Conception of Contract: Observing Basic Distinctions (Part I)' (2000) 16 *Journal of Contract Law* 1; Rick Bigwood, 'Conscience and the Liberal Conception of Contract: Observing Basic Distinctions (Part 2)' (2000) 16 *Journal of Contract Law* 191; Paul Finn, 'Unconscionable Conduct' (1994) 8 *Journal of Contract Law* 37; John Carter and Andrew Stewart, 'Commerce and Conscience: The High Court's Developing View of Contract' (1993) 23 *University of Western Australia Law Review* 49.

the substantive fairness of the transaction); the relationship between the parties and, in particular, any inequality of bargaining power between them at the time of contracting; and to an unfair compulsion of performance.

1 *Unconscionability in Relation to the Amount of the Agreed Sum*

When Lord Dunedin outlined principle 4(a) in *Dunlop*, he added an '[i]llustration given by Lord Halsbury in *Clydebank's Case*'. That illustration was as follows:

> For instance, if you agreed to build a house in a year, and agreed that if you did not build the house for £50, you were to pay a million of money as a penalty, the extravagance of that would be at once apparent.

Lord Halsbury then went on to note that, between such an extreme case and other cases, much will depend on the nature of the transaction, the 'thing to be done' and the loss likely to accrue.[42] Clearly, this illustration appears to relate to the amount of the sum. It might be argued that if unconscionability is used in this way, it would add little but emphasis to the words 'exorbitant' and 'extravagant' used in the relevant case law. Indeed, there is some authority, as was noted by Mason and Deane JJ in *AMEV-UDC,* for the notion that unconscionability need not be established to show that an agreed sum is a penalty. Rather, it only needs to be established that the agreed sum exceeds the loss that would potentially flow from the breach. The very definition of a penalty given by Lord Diplock in *Philip Bernstein (Successors) Ltd v Lydiate Textiles Ltd*[43] supports this idea:

> In the ordinary way a penalty is a sum which, by the terms of a contract, a promisor agrees to pay to the promisee in the event of non-performance by the proposor of one or more of the obligations *and which is excess of the damage caused by non-performance.*[44]

As an illustration of this view, Nicholls LJ in *Jobson v Johnson*[45] maintained that in law a penalty clause is a 'dead letter'. His Lordship was of the view that the correct position in law was that a penalty clause would remain in the contract and could be sued upon, but would not be enforced by the court beyond the sum which represented the actual loss of the party seeking payment.[46] In *Cooden Engineering*,[47] the agreed sum was found to be a penalty because, although it was not the case that the amount exceeded the greatest loss that could possibly follow on from the breach, it would have exceeded it 'in all except the exceptional case

42 *Clydebank Engineering* [1905] AC 6, 10.

43 (1962) 106 Sol Jo 669.

44 Quoted by Chadwick LJ in *Euro London Appointments Ltd v Claessens International Ltd* [2006] EWCA Civ 385, 439 (emphasis added).

45 [1989] All ER 621.

46 Ibid.

47 [1953] 1 QB 86.

where the car has become of no value'.[48] However, in *Robophone*,[49] Lord Diplock observed that '[t]he fact the sum is greater than the greatest loss suffered only gives rise to an inference that it is a penalty and can be rebutted'.[50] In Australia, Samuels J in *WT Malouf Pty Ltd v Brinds Ltd*[51] took the approach that it was not necessary to show unconscionability, but that a difference between the agreed sum and likely loss was sufficient:

> The words 'extravagant and unconscionable' in Lord Dunedin's test appear as elements in the formulation of one test designed to establish that a stipulated sum is a penalty. But it does not follow that that conclusion cannot be drawn unless the elements of extravagance and unconscionability are shown. It may be established otherwise, without recourse to those characteristics, that the sum is not a genuine pre-estimate, as I think it has in the present case. And the comparison is to be made not between the sum stipulated and the maximum benefit which might be derived if all contingencies were resolved in the promisee's favour, but between that sum and a genuine pre-estimate of damage.[52]

However, this approach has not found favour in subsequent Australian decisions.[53] Indeed, there may be quite valid reasons for a difference between the agreed sum and the likely damages, including the nature of the risk involved,[54] a point that is taken up later in this paper.

Alternatively, words such as 'exorbitant' and 'extravagant' might be subsumed into the term 'unconscionability'. See, for instance, Seddon and Ellinghaus,[55] who observe that in Lord Dunedin's formulation, 'the leading criterion is clearly "unconscionable" since it embraces the others'. Their approach was cited with approval by Rolfe J in *CFA Group v Mars Trading*.[56] Most Australian supreme courts, however, have tended to place these terms in the alternative. For instance, in *Challenge Finance*, Young J observed that the correct test is: 'whether the obligation which attaches ... upon termination is out of all proportion, extravagant, exorbitant *or* unconscionable having regard to the loss likely to be suffered by the owner'.[57]

In Australia, while it is not entirely clear in the majority of cases since *AMEV-UDC* that extravagance is subsumed into the word 'unconscionability', it is the case

48 Ibid 98 (Somervell LJ).

49 [1966] 3 All ER 128.

50 Ibid 143.

51 (1981) 11 ATR 687.

52 Ibid 702.

53 See, eg, *Challenge Finance* (1995) 217 ALR 264, 267, where Young J noted that although the magistrate in this case had stated the test correctly, 'he in fact applied the discarded mechanical test as to whether the liquidated sum exceeded the damages that could be obtained for breach of contract'.

54 See, eg, *Yarra Capital v Sklash* [2006] VSCA 109 (Unreported, Warren CJ, Chernov and Ashley JJA, 18 May 2006) ('*Yarra Capital*') and *PC Developments* (1991) 22 NSWLR 615.

55 Seddon and Ellinghaus, above n 36, [23.35].

56 [2001] NSWSC 112 (Unreported, Rolfe J, 22 February 2001) [61].

57 *Challenge Finance* (1995) 217 ALR 264, 266 (emphasis added).

that a mere comparison of the agreed sum and the anticipated loss is insufficient to justify court intervention. Where unconscionability is taken to refer to the difference between the agreed sum and the loss likely to flow from the breach, the courts will require something significantly more than a mere difference in amount. For instance, in *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd*,[58] Clarke JA concluded – explicitly approving the judgment of Mason and Wilson JJ in *AMEV-UDC* – that a party seeking to have a court intervene in an agreed sums clause would be required

> to satisfy the court that there was such a disproportion between the sum payable on termination, calculated in accordance with the terms of the contract, and the likely damage flowing to the appellant upon termination that it should be concluded that the pre-estimate was either extravagant or unconscionable.[59]

Even disproportion per se is not enough to ground judicial intervention, as the High Court observed in its most recent pronouncement on the penalties doctrine in *Ringrow*. In that case, Ringrow contracted to buy a service station from BP on 27 May 1999. Ringrow had conducted a service station business on the site for some years (since 1988) as a franchisee. The contract of sale was completed on 28 July 1999 and related transactions were entered into at the same time, including the BP Branded Privately Owned Sites Agreement ('POSA') and an Option Deed which provided an option for BP to buy back the service station on termination of the POSA. Clause 2.1 of the Option Deed provided that the price payable was its 'market valuation ... as an operational service station as determined by an independent valuer excluding any goodwill attaching to the business'.

At various times in 2002, Ringrow bought fuel from a supplier other than BP in breach of clause A4.2 of the POSA. BP served notice of breach and notice of termination pursuant to clause A13.2.1(a) of the POSA and then sought to exercise its option to buy back the service station under the Option Deed. Ringrow alleged, amongst other things, that clause 1.2(a) of the Option Deed was void and unenforceable as a penalty. It submitted that the exclusion of goodwill from the contract price, the cumulative imposition of the Option upon the liability to pay liquidated damages if BP enforced the latter liability before exercising the Option and what it termed the 'indiscriminate factor' (the fact that the right to exercise the option was unrelated to the extent or gravity of the breach) led to the conclusion that this was a penalty.

Hely J in the Federal Court upheld the validity of the termination and the Option.[60] The Full Court of the Federal Court (Beaumont J, Conti and Crennan JJ) dismissed an appeal by Ringrow.[61] Ringrow appealed to the High Court. At this point, the only live issue remaining to be decided was whether clause 1.2(a) of the Option Deed was a penalty.

58 (1989) 15 NSWLR 564 ('*AMEV v Artes Studios*').

59 Ibid 578.

60 *Ringrow Pty Ltd v BP Australia Pty Ltd* (2003) 203 ALR 281.

61 *Ringrow Pty Ltd v BP Australia Pty Ltd* (2004) 209 ALR 32.

In a joint judgment, Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ dismissed Ringrow's appeal. Upholding Lord Dunedin's principles, their Honours observed that there might be a 'suspicion' that BP was getting on the retransfer something worth more than the money paid for it (because of the exclusion of goodwill). But a mere difference, let alone suspicion of a difference, was insufficient. The comparison required something 'extravagant and unconscionable', to use the words of Lord Dunedin, or a 'degree of disproportion … relevant to the oppressiveness of the term to the defendant', to use the words of Mason and Wilson JJ in *AMEV-UDC*.[62] In this case, however, the evidence did not establish the existence of valuable goodwill, so Ringrow was unable to establish that the provision was extravagant and unconscionable.[63] Their Honours stated that:

> Exceptions from that freedom of contract require good reason to attract judicial intervention to set aside the bargains upon which parties of full capacity have agreed. That is why the law on penalties is, and is expressed to be, an exception from the general rule. It is why it is expressed in exceptional language. It explains why the propounded penalty must be judged 'extravagant and unconscionable in amount'. It is not enough that it should be lacking in proportion. It must be 'out of all proportion'. It would therefore be a reversal of longstanding authority to substitute a test expressed in terms of mere disproportionality.[64]

This test seems to suggest that the difference between the sums must be so extravagant as to be unconscionable. In this context, 'unconscionability' denotes an extremely exorbitant or extravagant difference between the agreed sum and the likely loss.

In my submission, this is the sense in which Lord Dunedin was using the term 'unconscionability'.[65] However, this approach is still open to criticism. Even allowing for the fact that the court requires a 'significant disproportion', the court intervenes, effectively, on the basis of the substantive fairness of the transaction. This is a development criticised by Lanyon, who queries why it is that courts might intervene on the basis of substantive fairness if this is not a consideration that justifies judicial intervention in other areas.[66] Indeed, if the parties are of relatively equal bargaining power, should a court intervene to adjust their agreement as to agreed liability arising from a breach? This brings us to the second possible application of the use of the term 'unconscionability'; that is, in reference to the relationship between the parties.

62 *AMEV-UDC* (1986) 162 CLR 170, 193.

63 *Ringrow* (2005) 224 CLR 656, 662.

64 Ibid 669.

65 This is a view shared by Carter and Peden, above n 17, 166, who consider the 'out of all proportion' test to be a reformulation of Lord Dunedin's test of whether the sum is 'extravagant and unconscionable'.

66 Lanyon, above n 8, 237.

2 *Unconscionability in Relation to the Relationship Between the Parties*

English courts have been reluctant to read 'unconscionability' in principle 4(a) of Lord Dunedin's formulation as justifying court intervention to strike down an agreed sum on the basis of an inequality of bargaining power. For instance, in *Imperial Tobacco Co v Parslay*,[67] Lord Wright observed that:

> I do not think the word 'unconscionable' ... has any reference to the fact that the parties were on an unequal footing. It does not bring in at all the idea of an unconscionable bargain. It is merely a synonym for something which is extravagant and exorbitant.[68]

Lord Slessor was similarly dismissive of inequality of bargaining power as a factor to be taken into account:

> the position of the contracting parties, be it equal or unequal, has nothing to do with the case ... There are methods by which contracts as a whole may be impeached for fraud or duress or whatever the cause may be. The only question here is whether the parties did or did not intend to estimate their damage. On that their relative economic or social position cannot in my opinion have any bearing whatsoever.[69]

Lord Romer similarly found that inequality of bargaining power was a 'wholly irrelevant consideration'.[70] More recently, Lord Woolf acknowledged the possibility of taking inequality of bargaining power into account when he observed in *Philips Hong Kong Ltd v Attorney-General (Hong Kong)*[71] that:

> Except possibly in the case of situations where one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract, it will normally be insufficient to establish that a provision is objectionably penal to identify situations where the application of the provision could result in a larger sum being recovered by the injured party than his actual loss.[72]

However, inequality of bargaining power is not a factor that features strongly in the UK case law.

The development of the doctrine of unconscionability in Australia, particularly since the landmark case of *Commonwealth Bank of Australia Ltd v Amadio*,[73] has made it almost inevitable that unconscionability in the context of the doctrine of penalties would raise questions as to inequality of bargaining power. Indeed, two

67 [1936] 2 All ER 515.

68 Ibid 521.

69 Ibid 525.

70 Ibid 526.

71 (1993) 61 BLR 41.

72 Quoted by Thompson, above n 12, 295.

73 (1983) 151 CLR 447 ('*Amadio*').

years after *Amadio*, in *Citicorp Australasia Ltd v Hendry*,[74] Kirby J lamented the fact that there was no authority for the proposition that an assessment of whether or not a sum was penal in nature could take into account the relative bargaining positions of the parties.[75]

However, a few short years later in *Esanda Finance Corporation Ltd v Plessnig*,[76] Wilson and Toohey JJ were critical of the decision by the Full Court of the Supreme Court of South Australia, which they criticised for overlooking the principle that an agreed sum is a penalty only if it is 'out of all proportion' or 'extravagant, exorbitant or unconscionable'.[77] Their view was that the decision of the Full Court placed too much emphasis on the superior bargaining position of Esanda, 'resulting in a conclusion that the mere possibility of unfairness lurking in the formula' contained in the relevant clauses was sufficient to lead to the conclusion that the agreed sum was a penalty.[78] This reprimand was not sufficient, however, to quash notions of inequality of bargaining power. The same year, Clarke JA in *AMEV v Artes Studios* explicitly approved the approach of Mason and Wilson JJ in *AMEV-UDC* and observed that this approach:

> draws a fair balance between the freedom of the parties to contract as they might wish and the public interest, which is reflected both in statutory instruments ... and judicial decisions, in protecting a weaker party from oppressive burdens or the unconscientious use of power by a stronger party.[79]

Acknowledgement of the relevance of the relationship between the parties can also be seen in *PC Developments* in the judgment of Cohen J. His Honour noted two lines of authority for resolving whether or not a sum is a penalty; the first based on equitable notions of conscience and the other based on a more mechanical application of doctrine and principle. In regard to the first, his interpretation was that for an agreed sum to be struck down as a penalty:

> There must ... be something, for example, in the nature of the provisions, the *circumstances of their negotiations, or the way in which the parties have acted in the exercise of their rights* which warrants the conclusion that for the plaintiff to bear the burden of the outcome of the risk is inequitable or unconscionable.[80]

He then referred to the judgments of Deane and Dawson JJ in *Stern v McArthur*[81] which emphasised that, for intervention of this kind, mere benefit to one party was insufficient; the party must also take advantage of 'another's special vulnerability

74 (1985) 4 NSWLR 1.

75 Ibid 23.

76 (1989) 166 CLR 131.

77 Ibid 141.

78 Ibid 141–2.

79 Ibid 577.

80 *PC Developments* (1991) 22 NSWLR 615, 626 (emphasis added).

81 (1988) 165 CLR 489.

or misadventure for the unjust enrichment of himself'.[82] This appeared to refer to unconscionability of the kind addressed in *Amadio*. Indeed, some commentators agree that this is exactly the sort of unconscionability Mason and Wilson JJ had in mind in *AMEV-UDC*[83] when they observed that the nature of the relationship between the parties and the unconscionability in the plaintiff seeking to enforce the provision could be taken into account in assessing whether an agreed sum was a penalty.

Acceptance of the validity of considering the relationship between the parties can be found in some subsequent state decisions.[84] For instance, in *Bezzina v Saxby Bridge Mortgages Pty Ltd*,[85] Giles JA observed that '[t]here was no suggestion that the relationship between the appellants and the respondent was other than that of willing parties to an unexceptional commercial transaction'.[86] Cole J in *Multiplex Constructions Pty Limited v Abgarus Pty Limited*[87] who observed that an agreed sum may constitute a penalty because it imposes an unconscionable burden upon the party in breach, observed that:

> Whether a burden is unconscionable may well depend upon the circumstances of the parties at the date of the contract, their perceptions at that time regarding their respective positions should breach of contract occur at a later and perhaps distant time, the equality or inequality of bargaining position at the date of contract, and the willingness or unwillingness of a party to accept an imprecise or in some respects ill-defined obligation to pay damages as the price of obtaining what presumably was regarded as a profitable contract. The relationships between the parties at the time of contract concerning the proposed clause and its imposition touch upon these matters, as does the question of their understanding of the likely imposition generated by the clause.[88]

At this point, however, unconscionability as a basis for invalidating an agreed sum clause tends to 'fade to grey', providing a general and ill-defined basis for judicial intervention.

82 *PC Developments* (1991) 22 NSWLR 615, 626.

83 See, eg, Lanyon's criticism of Rossiter on this basis: Lanyon, above n 8, 247.

84 See also Carter and Peden, above n 17, 162, who observe that there is no conclusive statement at appellate level as to inequality of bargaining power as a basis on which to strike down an agreed sums clause.

85 [2004] NSWCA 211 (Unreported, Giles and Hodgson JJA and Cripps AJA, 23 June 2004).

86 Ibid [31].

87 (1992) 33 NSWLR 504 ('*Multiplex*').

88 Ibid 509–10.

3 *Unconscionability in Relation to the Unfair Compulsion of Performance*

Much has been made in the case law about the significance of the purpose of the agreed sum in the determination of whether or not that sum is a penalty. For instance, Colman J in *Lordsvale Finance Plc v Bank of Zambia*[89] observed that the *Dunlop* case showed that:

> whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach. That the contractual function is deterrent rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss that might be sustained if breach occurred.[90]

Such an approach is not without its critics. Miller, for instance, argues that the legal bifurcation of agreed damages clauses rests on an assumption that 'they have an unequivocally divisible nature'. However, she sees this as problematic:

> Where the intention of the parties is not clear, or where their intention is twofold, (to include both a coercive and compensatory element to the clause), then predicating the legitimacy of judicial control on the parties having a singular purpose will be artificial.[91]

Nevertheless, in the UK, the distinction between clauses that are predominantly compensatory in nature and those that are deterrent has developed into a test of 'commercial justification'. Under this test, an agreed sum will be upheld, despite being greater than the likely loss 'if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach'.[92]

In earlier UK cases, there was some linkage drawn by the courts between the concept of unconscionability and the notion that an agreed sum was a penalty if it was imposed '*in terrorem*'. Thus, in the case of *Clydebank Engineering*, the Earl of Halsbury found that the argument that the particular sum was 'unconscionable or something which the parties ought not to insist upon, that it was a mere holding out something in terrorem' was not plausible.[93] A similar linkage, though not as overt and with some scepticism of the requirement that a penalty be *in terrorem* was made by Lord Radcliffe in *Bridge*. Lord Radcliffe was of the view that it

89 [1996] QB 752 ('*Lordsvale*').

90 Ibid 762; cited with approval in *Cine Bes Filmcilik v Yapimcilik v United International Pictures* [2003] EWCA Civ 1669, [13]; *Murray v Leisureplay plc* [2005] EWCA Civ 963, [110].

91 Miller, above n 25, 82.

92 *Lordsvale* [1996] QB 752, 763–4 (Colman J); endorsed in *Cine Bes Filmcilik v Yapimcilik v United International Pictures* [2003] EWCA Civ 1669, [15] (Mance LJ); *Murray v Leisureplay plc* [2005] EWCA Civ 963, [117] (Buxton LJ); applied in *Euro London Appointments Ltd v Claessens International Ltd* [2006] EWCA Civ 385, [31] (Chadwick LJ), who looked to the 'dominant contractual purpose' in assessing whether the relevant provision was struck down by the rule against penalties.

93 *Clydebank Engineering* [1905] AC 6, 13.

was not helpful to describe a penalty as a sum to be enforced *in terrorem*. He considered that this not only did not add anything of substance to an understanding of penalties, but could well obscure

> the fact that penalties might quite reality be undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet are ... entitled to claim the protection of the court when they are called upon to make good their promises.[94]

He went on to say later in his judgment:

> 'Unconscionable' must not be taken to be a panacea for adjusting any contract between competent persons when it shows a rough edge to one side or the other, and equity lawyers are, I notice, sometimes both surprised and discomfited by the plenitude of the jurisdiction, and the imprecision of rules that are attributed to 'equity' by their more enthusiastic colleagues.[95]

In Australia, Mason and Wilson JJ appeared to link the notion of unconscionability with the purpose of the clause in their acknowledgment that, historically, the court's intervention was attracted to relieve against provisions 'which are so unconscionable or oppressive *that their nature is penal rather than compensatory*'.[96]

There is relatively little Australian authority picking up on the potential link between the purpose of the clause and unconscionability, although there appears to be some sympathy in the state supreme courts for a return to an analysis of the purpose of the liquidated sums clause. For instance, Brereton J in *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd*[97] said that:

> A contractual provision may be said to be penal if its function is to operate *in terrorem* to induce performance (in respect of which phrase I respectfully agree with Staughton J's observation in *Export Credits Guarantee Department v Universal Oil Products Co*, to the effect that it remains useful in identifying a true penalty, despite the dislike of the phrase expressed by Lord Radcliffe in *Bridge v Campbell Discount Co Ltd*), or as a punishment for default, in the sense that it imposes an additional or different liability upon default; whereas a forfeiture involves loss or determination of an interest in property or a proprietary right in consequence of failure to observe a covenant.[98]

In Queensland, some recent decisions have been prepared to accept the approach taken by recent English courts in assessing the purpose of the clause. In *Beil v Pacific View (Qld) Pty Ltd & Ors*,[99] Chesterman J was prepared to accept and apply the judgment of Colman J in *Lordsvale*. His Honour held that contractual

94 *Bridge* [1962] AC 600, 622.

95 Ibid 626.

96 *AMEV-UDC* (1986) 162 CLR 170, 193 (emphasis added).

97 [2007] NSWSC 406 (Unreported, Brereton J, 27 April 2007).

98 Ibid [10] (citations omitted).

99 [2006] 2 Qd R 499.

function of the agreed sum in question was deterrent, rather than compensatory in nature, and that the clause was therefore a penalty.

In *Bartercard Ltd v Myallhurst Pty Ltd*,[100] the court appeared to adopt something like the 'commercial necessity' test. Thomas JA found that the relevant contractual provisions in question did not amount to a penalty. His Honour observed that the business survival of Bartercard depended upon the scheme continuing to function, such that Bartercard 'had a genuine interest in maintaining the scheme and its own entity':

> The conversion of a barter dollar deficit to a cash deficit in the event of a member failing to provide sufficient barter dollar credits in 30 days may fairly be described as a genuine pre-estimate of loss. Even if it is the maximum in the available range of estimates, it is within the available limit within which parties may contract without interference from the courts.[101]

His Honour further noted that '[t]he surveillance of courts over contracts is not based upon any underlying approval or disapproval of incentives or disincentives, which are a natural part of commercial arrangements'.[102] Davies JA also noted the 'commercial necessity' of the scheme.[103]

C *The Uncertainty as to Whether Unconscionability is a Separate Requirement in Determining Whether a Liquidated Damages Provision is a Penalty*

The uncertainties surrounding the use of the term 'unconscionability' in relation to the doctrine of penalties are exacerbated by ambiguity as to whether unconscionability is a separate and distinct basis for striking down an agreed sum. Originally, the judgments in this area suggested that a sum needed to be exorbitant, extravagant *and* unconscionable in order to justify court intervention. Thus, in *Clydebank Engineering*, the Earl of Halsbury used the term 'unconscionable and extravagant', although in the following paragraph claimed that it was impossible to lay down abstract rules as to what may be 'extravagant *or* unconscionable'.[104] Lord Davey used the term 'exorbitant and extravagant' and then referred to a penalty being 'an exorbitant and unconscionable amount'.[105] Some years later, however, McNair J in *Robert Stewart & Sons Ltd v Carapanayoti & Co Ltd*,[106] observed that:

100 [2000] QCA 445 (Unreported, Davies and Thomas JJA and Ambrose J, 27 October 2000).

101 Ibid [25].

102 His Honour went on to say that, in any case, there was nothing on the facts 'in the nature of a punishment for non-observance of a contractual stipulation. Neither is the pre-estimate extravagant, unconscionable or "judged as at the time of making the contract ... unreasonable in the burden which it imposes in the circumstances which have arisen"': ibid [26].

103 Ibid [5]; see also *CRA Limited v New Zealand Goldfields Investments* [1989] VR 873.

104 *Clydebank Engineering* [1905] AC 6, 10 (emphasis added).

105 Ibid 17.

106 [1961] 2 Lloyd's Rep 387.

> It seems to me – not here attempting, I hope, any new definition in a rather complicated field – that a payment would only be considered unconscionable and extravagant if it produced a grossly unreasonable result, either in amount or in the conditions under which payment was made, so that the Court would feel it unjust to allow such a sum to be recovered.[107]

In the event, his Honour found that the agreed sum in question was a 'perfectly reasonable businesslike way of providing machinery for dealing with a practical, concrete problem'.

In Australia, as we have seen, the judgment of Mason and Wilson JJ in *AMEV-UDC* referred to provisions 'which are so unconscionable *or* oppressive that their nature is penal rather than compensatory'.[108] In *O'Dea v Allstates Leasing System (WA) Pty Ltd*,[109] Deane J, approving Lord Dunedin's test in the *Dunlop* case, observed that an agreed sum would be penal if the pre-estimate of loss was:

> either extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach or, judged as at the time of making the contract, is unreasonable in the burden which it imposes in the circumstances which have arisen

Later cases then took up the proposition that unconscionability is a separate basis for invalidating an agreed sum. For instance, Clarke JA in *AMEV v Artes Studios* expressed the view that:

> contractual terms providing for the payment of agreed liquidated damages should be struck down as a penalty only if the agreed sum be either extravagant in amount or imposes an unconscionable or unreasonable burden upon a party. This approach would give full meaning to the distinction between a genuine attempt to agree as to the damage likely to flow from the event which triggers the operation of the clause and the imposition of a sanction or penalty against breach.[110]

The decision of Clarke JA was followed by Giles J in *Bridge Wholesale Acceptance Corporation (Aus) Ltd v Rega Pty Ltd*,[111] who found the relevant clause in a lease to be penal because it 'imposed an unreasonable burden on Rega to pay an extravagant or unconscionable amount'.

Similarly, in *Multiplex*, Cole J referred to the decision of Clarke JA in *AMEV v Artes Studios* in the following terms: '[h]is Honour there contemplates two alternative attacks, the first based upon extravagance of damage, and the second based upon unconscionability or imposition of an unreasonable burden upon a party'. Thus, in the view of Cole J, 'the Court may weigh any question of unconscionability, quite apart from an empirical examination of whether damage under the clause is

107 Ibid 392.

108 *AMEV-UDC* (1986) 162 CLR 170, 193.

109 (1983) 152 CLR 359.

110 Ibid 576.

111 (1992) Aust Contract R 90-019.

excessive'.[112] The approach in *Multiplex* was subsequently approved by Rolfe J in *CFA Group v Mars Trading*,[113]who determined the clause could not be described as penal, 'either on the basis that it is not a genuine pre-estimate of damages *nor* unconscionable'.[114]

The recent High Court decision in *Ringrow* did not address the issue of whether unconscionability is a separate ground upon which to strike down an agreed sum. In turn, the judges in *Yarra Capital* explicitly noted this was the case, but did not find it necessary to resolve the issue themselves. However, Chernov JA observed that neither the burden of the amount nor the relationship between the parties was sufficient to render enforcement of the clause unconscionable.[115] Ashley JA, on the other hand, observed that if the requirement was to be cumulative, that is, if it was necessary to show that the sum was both extravagant and unconscionable, the appellant's case would be more difficult as the parties were 'mature and experienced equals operating in the field of high risk, high return finance'.[116] At the same time, Ashley JA was of the view that despite this equality of bargaining power, 'each default interest provision arguably was capable of imposing a burden upon the first appellant ... very far exceeding the loss likely to be suffered by the respondent for being out of its money'.[117]

If unconscionability only refers to the amount of the agreed sum, there is no real issue as to whether unconscionability is a cumulative or separate requirement. However, if unconscionability refers to the relationship between the parties or the purpose of the agreed sum clause, then it is important to know whether it is a necessary element of judicial intervention.

III WHY UNCERTAINTY MATTERS

As was noted earlier, some commentators argue that court intervention on the basis of conscience and fairness is, in fact, at the heart of the doctrine of penalties. If this were the case, we might have expected that a considerable amount of uncertainty was inevitable, particularly as the doctrine of penalties is applied on a case by case basis. Judgments as to whether a clause is penal will, indeed, be a 'matter of degree' turning on the entire circumstances of the case.[118] Although such an approach will almost certainly give rise to some uncertainty, it can be

112 *Multiplex* (1992) 33 NSWLR 504, 509–10.

113 [2001] NSWSC 112 (Unreported, Rolfe J, 22 February 2001).

114 Ibid [75] (emphasis added).

115 Ibid [21].

116 Ibid [46].

117 Ibid [44].

118 Such an approach is supported by the US case of *Wallace Real Estate Inc v Groves*, 124 Wash 2d 881, 881 P 2d 1010 (1994), where the court said that the enforceability of a liquidated damages clause turns on whether the agreed sum is a reasonable pre-estimate of loss. Various factors might indicate reasonableness, but are not necessarily independent criteria needed to establish the validity of the clause. Similarly, in *Pollack v Calimag*, 157 Wis 2d 222, 458 NW 2d 591 (Ct App 1990), the court said that 'the overall single test of validity is whether the clause is reasonable under the totality of circumstances' and various factors would be taken into account in assessing reasonableness.

argued that the ability of the courts to guarantee or to generate certainty tends to be overstated, particularly in contract law where so many disputes arise over interpretation.[119]

Others commentators express concern, however, over this approach. For instance, Lanyon, as noted above, decried the development of the doctrine of penalties based on general appeals to fairness or unconscionability. She argued that such development must be principled and based on clearly articulated policy foundations.[120] A similar view was expressed by Clarkson et al, writing in the US context, who observed that although courts have generally come to efficient decisions in this area, explicit recognition of the basis for distinguishing between liquidated damages and penalties would help reduce the confusion in this area of the law.[121]

Although my own view is that the desire for certainty in contract law can often be misplaced, it seems to me that there is solid ground here for arguing for more certainty in relation to the doctrine of penalties. The advantages of liquidated damages provisions are well recognised: ideally, they promote certainty for the parties in relation to the financial consequences of breach (particularly in circumstances where it may be difficult to prove and assess the loss flowing from the breach) and assist the parties to avoid litigation. Even if the parties do go to court, a liquidated damages clause may eliminate the potentially heavy costs of proving the loss actually sustained.[122] This is because liquidated damages are not 'damages' per se and are therefore not 'subject to proof or concepts of remoteness or proximity for their ascertainment. They are simply triggered by the event [specified in the contract]'.[123] This being the case, a party may receive a windfall loss from enforcement of a valid liquidated damages clause.[124] By the same token, a party may be restricted to the agreed sum, even though the actual damages are in excess of that amount. However, the outcomes of breach are known to the parties from the outset. Hillman also observes that liquidated damages 'impress on promisors the importance of performance and create incentives for the promisor to perform', although the paradox of this is that 'if the incentive is too obvious and compels performance when the promisor's best interest is to break the contract', a court is likely to strike down the provision as a penalty.[125]

If the very purpose of these clauses is to minimise cost, avoid litigation, allocate risk and ensure some degree of certainty, it is ironic, to say the least, that these

119 David McLauchlan, 'A Contract Contradiction' (1999) *Victoria University Wellington Law Review* 33.

120 Lanyon, above n 8, 258.

121 Clarkson, Miller and Muris, above n 16, 390.

122 *Robophone* [1966] 3 All ER 128, 142 (Diplock LJ). See also Jonathan Hosie, 'The Assessment of Damages for Delay in Construction Contracts: Liquidated and Unliquidated Damages' (1994) 10 *Construction Law Journal* 214.

123 Hosie, above n 124, 224. This is because of the historical distribution between damages and debt. See further John Carter, Elisabeth Peden and Greg Tolhurst, *Contract Law in Australia* (2007) 867.

124 *Challenge Finance* (1995) 217 ALR 264, 280 (Young J): 'Mr Coles QC submitted that one does not look in this sort of case at the theoretical possibilities of over-recoupment. This, in my view, must be so'.

125 Hillman, above n 14, 725.

clauses, because of the uncertainty in the doctrine of penalties, might actually exacerbate, rather than alleviate, cost, litigation and uncertainty. There seems to be a general view amongst the courts that genuine liquidated damages clauses are beneficial. If this is the case, we should seek to encourage their use. But parties will be dissuaded from using these clauses if they are too readily open to litigation and potential invalidation.

IV WAYS IN WHICH UNCERTAINTY MIGHT BE MINIMISED

Before proceeding, a brief summary of the argument so far is in order. It has been argued that (1) unconscionability is a core concept in determining whether a liquidated damages clause is valid in Australia, but that (2) there is much uncertainty around this term, both generally and in its particular application to the doctrine of penalties. In a general sense, unconscionability is an uncertain concept that could be taken to justify a general right of the courts to intervene in contracts. In relation to the doctrine of penalties, there is ambiguity as to whether unconscionability relates to the agreed sum, the relationship between the parties or the purpose of the clause. There is also uncertainty as to whether unconscionability is a separate basis for striking down a liquidated damages clause or whether it is a cumulative requirement. It has therefore been argued that (3) the acknowledged advantages of liquidated damages are unlikely to be realised in the face of this uncertainty. Indeed, liquidated damages clauses may generate, rather than alleviate, costs and litigation.

Although there has been some reluctance to interpret unconscionability as referring to the relationship between the parties, I would argue that, in fact, it could provide greater certainty if coupled with the notion, proposed in *AMEV-UDC* and supported in *Ringrow*, that judicial intervention is only justified where there is a significant disproportion between an agreed sum and likely damages.

At the core of the doctrine of penalties is the question of whether or not the specified outcome for breach is a genuine pre-estimate of loss. Young J acknowledged this when he observed that: '[t]he question is whether the parties, taking their own interests into account, made a pre-estimate of the loss and bargained who was to bear the risks.'[126] The true purpose of a liquidated damages clause is to recognise and provide for the risk of default.[127] Under the classic theory of contract law, the

126 *Challenge Finance Ltd* (1995) 217 ALR 264, 273. On the question of a genuine pre-estimate, see Chernov JA in *Yarra Capital* [2006] VSCA 109 (Unreported, Warren CJ, Chernov and Ashley JJA, 18 May 2006) [44], who said that by a genuine pre-estimate of loss, Lord Dunedin was not saying that the party has to actually calculate anticipated loss or there is an arithmetic relationship between a penalty and a valid liquidated damages clause.

127 See *Beil v Pacific View (Qld) Pty Ltd* [2006] 2 Qd R 499, [27] (Chesterman J), noting that a substantial increase in interest on a loan 'was not underwritten by any increase in risk beyond that which was foreseen when the agreement was made'. See also Coopersmith, above n 24, 284–5, who notes that a primary purpose of an agreed damages clauses is to control risk: they are a type of insurance, the parties willing to agree to a set price today in order to avoid potentially greater loss tomorrow.

parties should be free to determine this aspect of their contract for themselves.[128] As Coopersmith observes, liquidated damages are often a more accurate estimate of compensation to the non-breaching party than conventional damages, as they take into account 'subjective aspects of risk and damages far better than the courts'.[129] At the same time, agreed damages clauses can be used oppressively by a party who is able to dictate contract terms.[130]

On this basis, unconscionability may be a useful tool with which to *limit* attacks on liquidated damages clauses if that term is understood as referring to a defect in the risk allocation process which allows one party to impose an exorbitant liability for breach on another. To this end, the following suggestions would apply:

1. Court intervention is clearly justified on the basis of unconscionability when it can be shown that the process for allocating risk has been distorted *and* the liability imposed is not compensatory but grossly disproportionate. A process for allocation of risk will be distorted when it is tainted by an unconscientious exploitation of superior bargaining power (or mistake).

2. Court intervention is not justified on the basis of unconscionability if there is an inequality of bargaining power but the allocation of liability is compensatory. There are two reasons for this: first, an inequality of bargaining power is not of itself indicative of unconscionability.[131] There must be an exploitation of the superior position for unconscionability to arise.[132] Secondly, as the party claiming under the clause can still claim common law damages if the clause is struck down, there is no advantage to be gained by invalidation. Of course, it may be that the inequality of bargaining power is so great as to strike down the *contract* rather than the agreed sum on the basis of unconscionability, duress or undue influence, but this is a different matter.

3. Court intervention is not justified even if there is a significant disproportion between the agreed sum and likely damages judged at the time of contracting if it can be shown that there was no defect in the process for allocating risk.

128 See *Carnovale v Pollack* [1995] NSWSC 133 (Unreported, Rolfe J, 6 November 1995), where Rolfe J refused to strike down the clause in question because to do so would effectively remove the rights of the parties to determine a genuine pre-estimate of loss. Note, however, that the validity of the clause is an objective test, so that in *De Francesch Builders Pty Ltd v Riley* [2000] WASC 301 (Unreported, Parker J, 17 October 2000), Parker J found that it was no bar to a finding that the agreed sums clause was valid that the parties had not produced evidence of the process of estimating the loss.

129 Coopersmith, above n 24, 285.

130 Ibid.

131 A person is not in a position of relevant disadvantage, constitutional, situational or otherwise, simply because of inequality of bargaining power. Many, perhaps most, contracts are made between parties of unequal bargaining power and good conscience does not require parties to contractual negotiations to forfeit their advantages or neglect their own interests': *ACCC v Berbatis Holdings* (2003) 214 CLR 51, 64 (Gleeson CJ).

132 This was the view unanimously taken by the Court in *ACCC v Berbatis Holdings* (2003) 214 CLR 51. Although this was in specific reference to the 'narrow' meaning of the term 'unconscionability', it is also the common thread in the wider version of the term. At first instance, French J held that 'circumstances of inequality do not of themselves necessarily call for the intervention of equity': *ACCC v Berbatis Holdings Pty Ltd* (2001) ATPR 41-778, [117]. This phrase was quoted with approval by Kirby J in the High Court decision: *ACCC v Berbatis Holdings* (2003) 214 CLR 51.

> Courts in decisions relating to other aspects of contract law have reiterated the view that the substantive fairness of contract terms is not a basis for judicial intervention at common law unless unfairness is the result of some unconscionable conduct in the formation of the contract, as in *Amadio*. This would mean that courts should be very reluctant to overturn agreed sums if there is no unconscientious use of power.[133]

4. Court intervention is not justified if it can be shown that there was a defect in the process of allocating risk and the liability for breach appears to be beyond compensatory but is not grossly so. This is because, if the agreed sum is struck out, the party not in default can still claim damages in the normal way. There will be 'difficulty and expense'[134] in so doing, which is largely obviated by an agreed sums clause. It does not, then, make good economic sense for the court to strike down such a clause unless significant disproportion is present, a view supported by *Ringrow*.

In particular, agreed sums in contracts between sophisticated commercial parties should be slow to attract judicial intervention. This is consistent with the approach taken in cases such as *GSA Group v Seibe PLC*,[135] where Rogers CJ pointed out that:

> The courts should not be too eager to interfere in the commercial conduct of the parties, especially where all of the parties are wealthy, experienced, commercial entities able to attend to their own interests.[136]

Such a view has found acceptance in some US courts. For instance, Judge Posner in *Lake River Corp v Carborundum Co*[137] suggested that:

> Deep as the hostility to penalty clauses runs in the common law ... we still might be inclined to question, if we thought ourselves free to do so, whether a modern court should refuse to enforce a penalty clause where the signator is a substantial corporation, well able to avoid improvident commitments.

Some years later, in *JKC Holding Co LLC v Washington Sports Ventures Inc*,[138] the court was faced with the question of whether a liquidated damages clause which stipulated that a US$30 million deposit would be forfeited if a bid to purchase

133 Again, this was a point made in *ACCC v Berbatis Holdings* in relation to the narrow view of unconscionability. Even so, Gleeson CJ distinguished between unconscientious exploitation and taking advantage of a superior bargaining position. The first justifies court intervention; the second does not: *ACCC v Berbatis Holdings* (2003) 214 CLR 51, 64.

134 *Yarra Capital* [2006] VSCA 109 (Unreported, Warren CJ, Chernov and Ashley JJA, 18 May 2006), [16] (Chernov JA).

135 (1993) 30 NSWLR 573.

136 Ibid 579. Similarly, in *Qantas Airways Ltd v Dillingham Corporation* [1987] ACL 35-692, Rogers J claimed that for such parties to invoke the protection provided by the law 'for the elderly, the illiterate and the financially oppressed is to move into a totally inappropriate field of discourse'. See also *Austotel Pty Ltd v Franklins Selfserve Pty Ltd* (1989) 16 NSWLR 582, 585 (Kirby J), who later affirmed this view in *ACCC v Berbatis Holdings* (2003) 214 CLR 51, 87.

137 769 F 2d 1284 (7th Cir 1985).

138 264 F 3d 459 (4th Cir, 2001).

a professional football team failed, was a penalty. The clause was upheld, the court observing that '[g]iven the quality and quantity of lawyers working on its behalf, the sophistication of the parties and the parity of their bargaining power, [the defendants'] claims that this provision is illegal and was imposed on them in terrorem is unsubstantiated by the evidence and defies common sense'.[139]

Of course, a significant disproportion may put a court on notice that it should investigate the risk allocation process to ensure that the sum was not the result of an unconscionable use of superior bargaining power. Further, the reluctance to intervene as between sophisticated commercial parties does not preclude intervention between commercial parties where there is a serious or gross inequality of bargaining power.[140]

V CONCLUSION

The doctrine of penalties has always been plagued by uncertainty. The emphasis in Australian jurisprudence on unconscionability as a key factor in determining whether a clause is a penalty has contributed to this uncertainty. This paper has argued that, if unconscionability is to remain a requirement of the test for the validity of an agreed sums clause, it should be used in such a way as to narrow, rather than widen, the potential for dispute. To this end, the paper has made some suggestions for when court intervention may or may not be warranted. It is submitted that these suggestions are in keeping with the High Court's relatively restrictive approach to penalty clauses in *Ringrow*, as well as its more restrictive approach to unconscionability in *ACCC v Berbatis Holdings*.

139 See also *Wallace Real Estate Inc v Groves*, 124 Wash 2d 881, 881 P 2d 1010 (1994) where the court said that the sophistication of the parties 'may point to the increased enforceability of liquidated damages provisions in commercial agreements'. See also Charles Goetz and Robert Scott, 'Liquidated Damages, Penalties and the Just Compensation Principle' (1977) 77 *Columbia Law Review* 554.

140 *ACCC v Berbatis Holdings* (2003) 214 CLR 51, 96 (Kirby J).