Society of Construction Law (New Zealand) Lecture

'The Penalties Doctrine in International Construction Contracting: Where to from here?'

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1. Introduction

I am honoured to have been invited by the Society to deliver this lecture and am most grateful to Michael Weatherall for his efforts in coordinating this evening.

I have the pleasure of addressing tonight an area of law which has been the subject of much attention, change and scrutiny in recent times. In December last year, the Supreme Court of England and Wales delivered its landmark decision in *Cavendish*[2] which modified the English doctrine of penalties as it stood for the last century, and steered English law in a new direction. Just under one month ago, the High Court of Australia delivered its judgment in the *Paciocco*[3] appeal. It is apposite to reflect on the development of liquidated damages in commercial law and the law of contracts, and in particular, cast a critical eye over the practical effect that these developments have in the construction law context.

To begin with, it should be noted that construction disputes have significantly contributed to the development of the common law. In Australia, for instance, the case of *Codelfa Construction v State Rail Authority* is a seminal example.[4] That case involved a dispute arising out of the construction of a Sydney rail tunnel. In the course of its decision, the Australian High Court characterised the doctrine of frustration and determined the application of implied terms in contract law for decades to come. In the realm of equity, *Waltons Stores (Interstate) Ltd v Maher*[5] is another example, where promissory estoppel was established as a cause of action in its own right. This influence of construction on the common law is not restricted to Australia, but similarly exists in many other jurisdictions.

It is ironic therefore that disputes arising from construction contracts have had little influence on the doctrine of penalties and its relationship with liquidated damages clauses, despite the fact that these clauses are, almost invariably, found in construction contracts. Rather, decisions relating to this area of law have come from other areas of commercial life. To practitioners and students of construction law, this gives rise to two questions:

- what do these decisions mean for the law of liquidated damages and penalty clauses; and
- do these decisions adequately address issues that are unique to construction contracts?

To answer these questions, I will be delivering my lecture tonight in five parts:

- First, I will contextualise the discussion on liquidated damages by examining their place in the construction world and in the common law;
- Second, I will examine the law as it stood in England, New Zealand, Australia, and many other common law jurisdictions for the last century, as well as its implications for construction contracts;
- Third, I will discuss the *Cavendish* decision and its impact on the construction and penalties landscape;

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[2] *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis* [2015] UKSC 67 ('*Cavendish*').

[3] *Paciocco & Anor v Australia and New Zealand Banking Group Limited* [2016] HCA 28 ('*Paciocco*').

[4] (1982) 149 CLR 337.

[5] (1988) 164 CLR 387.

- Fourth, I will provide an analysis of the recent decisions of the Australian High Court in *Andrews* and *Paciocco*; and

- Finally, I will compare those analyses with the position in civil law jurisdictions and draw some conclusions on the comparative benefits of alternative legal approaches to addressing this important issue.

It is my goal tonight to contribute to a discussion that the international construction community must have. There are many benefits and challenges arising out of the various ways in which it might approach the doctrine of penalties, which require consideration for the future.

2. Context

Construction contracts and liquidated damages clauses go hand in hand. Most construction contracts, particularly international ones, are implemented over many years and entail considerable uncertainty. Exposure to a broad range of risks, including political, environmental and financing risk, often encapsulated in a fixed price, induces significant stress in such contracts. By providing for a fixed sum payment in the event of non-compliance with particular obligations, usually relating to timely performance, liquidated damages clauses help avoid the massive time and expense of proving losses in an area where such proof is notoriously difficult.

Liquidated damages for delay are but one area where agreed fixed sums in the event of breach operate. Others include abatements of price for plant non-performance both before and after commencement of operation, reduced service fees for operational non-performance and payments upon failure to maintain the employment of key personnel.

By agreeing in advance on the amount to be paid for a specified delay, the interest of the Project Owner in receiving the project on time, or being compensated for the delay, is protected. Further, such an agreement places the Contractor on notice about the extent of damages for which it may be liable. In this context therefore, liquidated damages promote economic efficiency and reduce uncertainty in major projects.

Two aspects need to be identified. First, the actual loss for an Owner arising from a Contractor's delayed performance can be wholly disproportionate to the contract value, and liquidated damages are sometimes used as a limitation of liability for delay. Second, general damages may not adequately compensate a party for non-performance. Many public infrastructure projects, such as roads, bridges and defence asset acquisition, are not acquired for profit, but rather for the benefit of the community. The value of these projects cannot be measured in cash flows or revenue streams, and a tribunal therefore cannot accurately value these intangible losses such as community disadvantage and political embarrassment. A liquidated damages clause, however, can help resolve this challenge where a figure has been determined and agreed.

Due to these benefits, it is clear that there is a strong policy interest in supporting the use of liquidated damages clauses in construction contracts. Nevertheless, the doctrine of penalties still operates as a limitation on the ability of parties to agree to their own liquidated damages. This is interesting to say the least, as there is a long tradition of the common law respecting the agreements of parties. Only by applying principles of equity will the Courts interfere with the doctrine of freedom of contract, and even then, equity ordinarily does not disturb the *substance* of an agreement, merely the *procedural* aspects by providing relief from injustices in formation such as unconscionable conduct or mistake.[6]

So from where does this penalties doctrine come?

[6] See Thomas Ho, 'Against *Cavendish*: Towards a Procedural Conception of the Penalty Doctrine' (2016) 33(4) *The International Construction Law Review* (forthcoming) for an interesting analysis on the relationship between procedure and the penalties doctrine.

Let me take you briefly to the late 15th and early 16th Century. The penalty rule then operated as a form of relief from defeasible bonds. These bonds were written legal instruments designed to secure performance of a specified condition through the legal threat of a sum of money as damages, should the obligee fail to perform. The problem this created was that bond holders could bring common law actions in debt for the specified amount when non-performance occurred, enabling a bond holder to claim for an amount unrelated to, and often significantly more than, their actual losses. This is because an action in debt made it unnecessary for holders to substantiate their losses, and the common law, of course, enforced these bonds.

Equity, however, saw the intention of these bonds as security only and reduced their enforcement so that the obligee paid only actual damages, interest, and costs.[7] Two principles were applied in this exercise; first, that the bond was intended to secure the recovery of actual damage, and second, that the security could be achieved by staying the Court proceedings on terms that the defendant paid damages.[8]

Thus, in *Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd*, the New Zealand Court of Appeal noted that the penalty doctrine operates fundamentally as a protection against the possible inequality of bargaining power that may arise between contracting parties, particularly in the consumer context.[9] The Court, when confronted with potential penalty clauses, must strike a balance between two competing interests. On the one hand, there is the desirability of legal and commercial certainty, which rests upon the doctrines of freedom of contract and party autonomy. On the other hand, there is a need to protect vulnerable contracting parties from certain predatory tactics open to use by larger commercial players.[10]

Given this, one may question whether the penalties doctrine has *any* role at all to play in construction contracts, which generally involve sophisticated parties who have the benefit of both commercial experience and legal advice and representation. This situation is removed from where there is inequality of bargaining power involving consumers.

Indeed, in construction cases, the amount of any liquidated damages will be arrived at after extensive commercial due diligence, calculation, and (often) negotiation. Upsetting this agreement can create further uncertainty in a field where it is already rife, and in doing so, effectively disregard the extensive consideration and resources the parties have invested in the creation, and pricing of the effect of, the clause.

History has however shown that the penalties doctrine will continue to play a fundamental role in the context of construction projects. I intend to explore the policy considerations that underlie current legal applications of the penalties doctrine in New Zealand, and potential directions in which the doctrine might usefully be developed in the future. The need for commercial certainty in large commercial contracts, such as those in the construction world, is in my view a particularly important consideration in the development of the common law.

With these thoughts in mind, I turn to the common law of the last century.

3. The Last Century

Until recently, the historical decisions governing the law on penalties in England, Australia and New Zealand were the early 20th Century House of Lords cases of *Clydebank v Castaneda*[11] and *Dunlop Pneumatic Tyre v New Garage Motor.*[12] Together, these cases confirmed the general principle that where

[7] *Cavendish* [2015] UKSC 67, 2-3 [4] (Lords Neuberger and Sumption), quoting *Sloman v Walter* (1783) 1 Bro CC 418, 419 (Lord Thurlow LC).

[8] *Cavendish* [2015] UKSC 67, 3 [5] (Lords Neuberger and Sumption).

[9] *Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd* [2004] 2 NZLR 614, [57]-[58] (Gault P, Blanchard and McGrath JJ).

[10] See *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 194 (Mason and Wilson JJ); approved by the New Zealand Court of Appeal in *Amaltal*.

[11] *Clydebank Engineering and Shipping Co v Don Jose Ramos Yzquirdo y Castaneda* [1905] AC 6 ('*Clydebank*').

[12] *Dunlop Pneumatic Tyre Co Ltd v New Garage Motor Co Ltd* [1915] AC 79 ('*Dunlop*').

a contract clause stipulates payment *in terrorem*, that is as a legal threat given with the intention of compelling performance of the contract, the Courts will find that clause to be a penalty clause and unenforceable. By contrast, a clause which stipulates payment in an amount reflecting a genuine pre-estimate of damage is characterised as a liquidated damages clause, and is thus enforceable.

Whilst many jurisdictions now have their own leading authorities, it is useful still to explore *Clydebank* and *Dunlop* in some detail, as new authorities build on these cases.

3.1 Clydebank

A construction case of sorts, Clydebank was a Scottish shipbuilding company retained by the Spanish Government for the purpose of constructing four torpedo boats within specified time frames. The contract provided a payment of £500 per week for each vessel delayed in delivery. Clydebank had accumulated 135 weeks of total delay, and an according debt of £67,500. One of the challenges brought was that the clause was fixed without consideration of any probable damage caused by late delivery, and was in effect a penalty. Their Lordships rejected this argument, finding that the clause was neither 'unconscionable nor extravagant',[13] nor issued *in terrorem,* and was always intended between the parties to be a liquidated damages clause.

Their Lordships reached this conclusion after looking to the circumstances of the case as they were at the time that the contract was entered into. Four main factors contributed to their decision: first, that timely performance was of the essence to both parties; second, that the damage was of a nature which was indeterminable at the time of entering into the contract; third, that the figure was itself suggested by the shipping company; and fourth, that the amount was limited to weekly incrementalism.

Importantly, the indeterminable nature of the actual damages was due to the public, and not commercial, purpose of the torpedo boats. Therefore, little to no empirical data could be used to quantify in damages the amount that the Spanish Government would be losing in the event of late delivery. As mentioned earlier, this challenge is in no way unique to the present time.

Thus, in *Clydebank*, some recognition was given to the fact that the parties, given their backgrounds and the context of the contract formation, were in a better place than the Courts to decide how they would approach damages in the event of breach. One could even say that there was an unspoken recognition of freedom of contract with which their Lordships were mindful to avoid interfering.

3.2 Dunlop

Ten years later, their Lordships delivered their decision of *Dunlop*. Dunlop was a tyre manufacturer who had an agreement with New Garage, a retailer, not to resell their tyres for a price lower than its listed price. Breach of this clause made New Garage liable to pay £5 per tyre "by way of liquidated damages and not as a penalty" as the contract stipulated. New Garage breached the sale agreement and challenged the £5 provision on the ground that, despite being labelled as liquidated damages, it was actually a penalty. The Court held in favour of Dunlop, finding that a significant part of the damage done by this breach was indirect damage to Dunlop's business model.

Their Lordships considered that the substantial whole of Dunlop's business was done through sale agreements with retailers, and the effect of one retailer underselling was to harm the business of Dunlop's other retailers. Those retailers would then turn elsewhere from Dunlop for their supply, and subsequently damage Dunlop's business. As this damage was an unquantifiable amount, it was not relevant to their Lordships that the clause would come into effect no matter the level of deviation from the listed price.

In *Dunlop*, their Lordships emphasised that the law against penalties will be attracted only where a contract provides for an agreed sum to follow a breach of contract that exceeds what can be regarded as a genuine pre-estimate of probable damage.[14] To assist with this determination, Lord Dunedin set out four principles he considered likely to assist. These principles have been applied consistently in both New

[13] *Clydebank* [1905] AC 6, 10 (Lord Halsbury).

[14] *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662 [10] (Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ) ('*Ringrow*').

Zealand[15] and Australia[16] and, as they are known to any student of contract law, I will not list them all. Instead, I will simply paraphrase the two that are most relevant for tonight's discussion:

- a clause will be held to be a penalty if the sum stipulated is extravagant and unconscionable in comparison with the greatest loss that could conceivably be proved to have followed from the breach; and

- that losses are indeterminable is no obstacle to the sum stipulated being a genuine pre-estimate of damage. To the contrary, that is precisely the situation when it is probable that pre-estimated damage was the true bargain between the parties.

Important attention should be paid to the language used in the first principle. Given that the penalties doctrine infringes the ability of parties to agree to whatever they desire, there must be clear reason for this intervention. Thus, the Australian High Court noted in *Ringrow* that the test is expressed in exceptional language, and the clause must be 'extravagant and unconscionable'. It is not enough that it is lacking in proportion. It must be out of all proportion.[17] This is necessarily linked to the important element of remoteness of damage which was laboured on in *Cavendish* and which we will discuss in detail later.

Coming out of *Clydebank* and *Dunlop* are some relevant considerations for construction contracts. In both cases, the Courts recognised the importance of liquidated damages clauses in situations where precise pre-estimation of loss is impossible. As a result, those clauses were upheld. In the situations contemplated by many construction contracts, this may well be the case and this may be sufficient to protect the parties' agreement from the penalties doctrine. However, some relevant limitations also exist.

Consider the situation where a government contracts to build a power station. This power station is constructed, however it does not provide the electricity capacity which is required. Such a breach will sound in general damages, and it cannot be said that pre-estimating any loss suffered is impossible. Nevertheless, the monetary damages recoverable at law for this design fault may not adequately represent the interest of the government in having the power station available for potential use. A focus on pre-estimates of loss can place the Court in a challenging situation in construction scenarios such as this, and leads to difficulties in the consistent application of the doctrine. This subsequently makes it difficult for contract drafters to create liquidated damages clauses that recognise their unique interests, and are also enforceable.

Further still, in these cases, common law Courts recognised that their jurisdiction allows them only to either honour a liquidated damages clause, or strike it down entirely. The Court holds no jurisdiction to modify the liquidated damages agreed upon to bring it to a more sensible level. Thus, in those scenarios, a party is left to proving its losses in accordance with the general law, carrying with it all those associated disadvantages in the construction context.[18]

3.3 Other Common Law Jurisdictions

From this background, the law in India[19] and related jurisdictions such as Malaysia[20] and Brunei[21] has developed on substantially different lines. In these countries, there is no principled distinction made

[15] *ISAC New Zealand Ltd v Managh* [2013] NZHC 3242 [5 December 2013], [116] (Mallon J).

[16] *Ringrow* (2005) 224 CLR 656, 663 [12] (Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ); *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28, 5 (French CJ), [27] (Kiefel J), [115] (Gageler J) [270] (Keane J), [317] (Nettle J).

[17] *Ringrow* (2005) 224 CLR 656, 669 [32] (Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ).

[18] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216-7 [10] (French CJ, Gummow, Crennan, Kiefel and Bell JJ).

[19] *Contracts Act 1872* s 74.

[20] *Contracts Act 1950* s 75. See *Selva Kumar a/l Murugiah v Thiagarajah a/l Retnasamy* [1995] 1 MLJ 817 for an analysis of this provision. For present purposes, the law is substantially similar to the forthcoming analysis on India. s 75 of the Contracts Act.

[21] *Laws of Brunei, Chapter 106 (Contracts)* s 75.

between a penalty and a liquidated damages clause,[22] nor a general entitlement to receive the agreed amount upon the occurrence of a breach. Instead, the Court must consider two distinct issues.

First, in the case where a party can prove their actual losses, it must do so and the liquidated damages clause cannot be relied upon to dispense with proof.[23] Second, in the event that a party cannot prove their losses, or this is difficult to do, the Court has the power to award 'reasonable compensation' not exceeding the amount agreed to by the parties.[24] The liquidated damages clause therefore operates as an upper limit on damages, however the total amount awarded can be adjusted to anywhere beneath this ceiling.

In my view, this approach to the penalties doctrine limits the utility of liquidated damages clauses and the certainty these clauses can offer. This is because it substantially limits the circumstances in which a liquidated damages clause is given (even partial) effect. It further does not appropriately recognise the benefit in allowing fixed compensation without a need to evidence losses, nor the fact that not all losses are measureable, or even observable.

From a practical perspective however, liquidated damages clauses still have some utility. This is because damages for delay, and similar breaches, will often fall into the category of cases for which a party cannot readily establish their losses.[25] As discussed, the Court then has the power to award reasonable compensation in response to that breach. If the amount that the parties have agreed to in the liquidated damages clause is a genuine pre-estimate of loss, the Court will likely defer to that figure,[26] and consider it to be reasonable compensation.[27] Thus, the agreement of the parties is often upheld in practice.

Therefore, although the position in India is more restrictive in comparison to England and New Zealand, the evidential difficulties associated with most construction contracts mean that part of the utility of a liquidated damages clause still remains. The more relevant takeaway for our discussion however is the notion of 'reasonable compensation', to which I will return later. For now however, it is time to take a look at the recent developments in England with the decision of *Cavendish*.

4. Cavendish

No discussion of *Cavendish* can begin without the lament of their Lordships for the quasi-statutory status to which Lord Dunedin's passage in *Dunlop* has risen in subsequent case-law.[28] Lord Dunedin did not suggest that his passages were more than just general guidelines, and neither did any other Law Lord in *Dunlop* expressly adopt his principles. Of particular note to their Lordships in *Cavendish* was the fact that Lord Dunedin himself acknowledged that his four tests were intended as a simplistic approach to basic penalty clause disputes, whereas in larger, more complex cases, the essential question to be asked was whether the clause in question was 'unconscionable or extravagant'.

But 'unconscionable or extravagant' in what context?

Lords Neuberger and Sumption were of the opinion that Lord Atkinson's passage in *Dunlop*, which respected the broad interests of contracting parties, was more instructive than Lord Dunedin's.[29] They likened this approach to the *Clydebank* decision, where the appropriate question to answer was 'what was the nature and extent of the innocent party's interest in the performance of the relevant obligation?'[30] In a modern context, this is synonymous with asking for the commercial justification for the inclusion of

[22] *Fateh Chand v. Balkishan Das* (1964) SCR (1) 515, 526.

[23] *Maula Bux v. Union of India* (1970) SCR (1) 928, 933; *Kailash Nath Associates v DDA* (2015) 4 SCC 136.

[24] *Indian Contracts Act 1872* s 74; *Fateh Chand v Balkishan Das* (1964) SCR (1) 515, 526-7.

[25] See, eg, the analysis in *Sakinas Sdn Bhd v Siew Yik Hau & Anor* [2002] 3 CLJ 275.

[26] *ONGC Ltd v Saw Pipes Ltd* (2003) 5 SCC 705.

[27] *Maula Bux v Union of India* (1970) SCR (1) 928, 933-4.

[28] *Cavendish* [2015] UKSC 67, 10-1 [22] (Lords Neuberger and Sumption).

[29] *Cavendish* [2015] UKSC 67, 11-2 (Lords Neuberger and Sumption).

[30] *Cavendish* [2015] UKSC 67, 12 [23] (Lords Neuberger and Sumption).

the liquidated damages clause. Thus, their Lordships in *Cavendish* revolutionised the way in which the doctrine of penalties is to be approached in the United Kingdom in the following words:

> The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.[31]

A "genuine pre-estimate of loss" is no longer the relevant test to be applied in the UK, nor whether the clause is aimed at deterring breach. Instead, *Cavendish* asks the Courts to balance the clause against the legitimate interest of the party seeking to enforce it or, alternatively, to consider whether there is a commercial justification for the clause.

It is instructive to consider the application of this test. One of the appeals in *Cavendish* concerned a parking ticket dispute in which a Mr Beavis overstayed a 2 hour free parking limit and was fined £85 in accordance with numerous warnings around the car park.[32] Whilst the owner of the car park conceded the fine was not a genuine pre-estimate of damage (having suffered little to no damage), their Lordships found it was an effective clause for a number of cumulative reasons including that the owner had legitimate interest in obtaining income to cover its costs and ensuring a steady flow of new customers to the retail outlets for which the car park catered.

The other appeal concerned a share purchase dispute which contained a restrictive covenant preventing the seller, Makdessi, from engaging in competing activities.[33] Makdessi subsequently did so. The covenants entitled the buyer, Cavendish, to withhold the final instalments for the shares and to acquire them for a lower price that did not take into account goodwill. Whilst this clause did not directly penalise Makdessi, their Lordships considered that a clause disentitling a party to a benefit otherwise due could rightly constitute a penalty, however, that the covenants were not penalties as Cavendish had legitimate interest in protecting its goodwill and competition.

Common to the determination of both appeals was a broader examination of the legitimate interest of a party in receiving performance, and not a mechanical fixation on possible loss. This is a particularly useful development in the construction industry given the fact that many construction contracts have a broader interest than just money, being also concerned with community expectations, reputation and goodwill.

In *Cavendish*, their Lordships also raised the issue of forfeiture clauses, which are commonly employed in construction contracts. Under such clauses, a party can lose accrued rights on the transpiration of certain events. Naturally, as such clauses involve forfeiting rights or money, they can come within the penalties doctrine. Lord Hodge however also considered that even if a clause is not a penalty clause as a matter of characterisation, there may still be scenarios in which the breaching party could be granted relief against forfeiture in equity after considering the position of the parties after the breach.[34] This could operate as a further limitation on the efficacy of such clauses, but exactly how this will pan out remains to be seen.

A consequence of the refocus of the penalties doctrine on legitimate interest is that the Court will also be more concerned with the agreement of the parties, who understand their own interests better than the Court, and thus freedom of contract will be respected. As a result, I have no reservation in observing that the decision in *Cavendish* provides potentially more sensible commercial outcomes in the sense that it provides more flexibility take account of the particular interests of contracting parties.

The decision, however, did not address common law courts' inability to modify or adjust the amount of liquidated damages claimed, nor was it a question put to their Lordships. As it stands, a court's determination that the amount in question is out of all proportion even to the party's legitimate interest would be struck down, and the injured party would remain deprived of full compensation.

Despite this, *Cavendish* is still a positive decision which has extended the categories of interests liable for compensation.

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[31] *Cavendish* [2015] UKSC 67, 17 [32] (Lords Neuberger and Sumption).

[32] *ParkingEye Limited v Beavis* [2015] UKSC 67.

[33] *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67.

[34] *Cavendish* [2015] UKSC 67, 99 [227] (Lord Hodge).

5. Australia

Slightly closer to home in Australia, the two most recent authorities on the doctrine of penalties are the 2012 High Court decision of *Andrews v Australia and New Zealand Banking Group*,[35] and its 2016 counterpart, *Paciocco v Australia and New Zealand Banking Group*.[36] I will deal with both of these cases in turn, starting with *Andrews*.

5.1 Andrews

In 2011, Mr. Andrews led a 38,000 strong class action against ANZ alleging that certain bank fees imposed were penalties at law. Eventually, the case was removed to the High Court to determine an important anterior question: what events need to unfold in order to engage the penalties doctrine?

Prior to *Andrews*, the penalty doctrine was understood to be engaged following a breach of contract.[37] This was because it was thought that the rule against penalties had ceased being a rule of equity, but had instead become one of the common law.

In *Andrews*, the High Court disagreed. It found that the penalties rule still exists both in common law and equity and, although the common law rule is only engaged upon a breach, equity is not so constrained. The Court in *Andrews* went on to assert that a contractual stipulation imposes a penalty on a party if, as a matter of substance, it is collateral to a primary stipulation in favour of the other party, and that collateral stipulation, upon failure of the primary stipulation, imposes an additional detriment to the benefit of the other party. This is because the collateral stipulation would be in the nature of a security for and *in terrorem* of the satisfaction of the primary stipulation.[38]

In making this statement, the High Court did not modify the penalties doctrine but rather significantly expanded its scope to potentially any contractual stipulation, rather than just breach. This development has received substantial academic and judicial criticism, largely revolving around its implications on the drafting of contracts.[39]

In construction, consider, for example, the case of performance-based contracts with variable payment dependent on the standard or speed of performance. In such a scenario, delivering a project slightly earlier or later is not a breach of contract; the parties simply agreed on a sliding scale in their commercial discussions on price. Nevertheless, post-*Andrews*, such a pricing scheme could fall foul of the rule against penalties if the reduction in payment is out of all proportion to the actual loss caused by the failure to meet that performance indicator.

Another example that was previously thought immune from the penalties doctrine is that of contingent obligations in a contract. Consider a contract that allows for termination in the event of the insolvency of the Contractor, as well as a forfeiture of accrued rights.[40] Under the *Andrews* test, such a termination right could be considered a collateral stipulation imposed to provide a detriment to the other party, and thus fall within the scope of the penalties doctrine.

With even limited imagination, other examples within the *Andrews* doctrine can be identified. Noting these examples, in *Cavendish*, Lords Neuberger and Sumption were unequivocal in their criticism surrounding this area. It is worth quoting their Lordships:

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[35] (2012) 247 CLR 205.

[36] *Paciocco & Anor v Australia and New Zealand Banking Group Limited* [2016] HCA 28.

[37] *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292.

[38] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [10] (French CJ, Gummow, Crennan, Kiefel and Bell JJ).

[39] See, eg, Anthony Gray, 'Contractual Penalties in Australia Law After Andrews: An Opportunity Missed (2013) 18(1) *Deakin Law Review* 1, 14-25.

[40] See Albert Monichino, 'Termination for Convenience: Good Faith and Other Possible Restrictions' (2015) 31(2) *Building and Construction Law Journal* 68 for an analysis on termination for convenience clauses.

> "Modern contracts contain a very great variety of contingent obligations. Many of them are contingent on the way that the parties choose to perform the contract...The potential assimilation of all of these to clauses imposing penal remedies for breach of contract would represent the expansion of the courts' supervisory jurisdiction into a new territory of uncertain boundaries, which has hitherto been treated as wholly governed by mutual agreement."[41]

Thus, although it can be argued that the *Andrews* decision limits the ability of a party to circumvent the doctrine by skilful drafting, it has significant uncertain and negative implications on commercial contracts. To that extent, the decision in *Andrews* is concerning in the construction context, and there is an argument open that the courts are no longer regulating the remedies flowing from the party's agreement, but also some aspects of the core agreement itself.[42]

However, it would be wise not sound the alarm bells too hastily. *Andrews* is still a recent development with no substantial guidance available as to the circumstances of its application. Although it would be sensible for parties to examine their contracts in accordance with the ruling, it is to be hoped that the forthcoming case law recognises the commercial problems that *Andrews* could create and provide some more clarity.

Effect on New Zealand:

The relevance of the prior discussion is that *Andrews* has had the effect of creating divergent lines of authority between Australia and the UK with regards to what is necessary to enliven the doctrine of penalties. As has been noted, this is commercially significant in the construction sector.

Which line of authority will be followed by New Zealand however is, as yet, unclear. In late 2013, the New Zealand High Court in *ISAC New Zealand Ltd v Managh* recognised that this was a question that needed answering, but declined to answer it in that case.[43]

It is to be hoped that, consistent with the benefits of a restrictive approach to penalties in the construction context, the New Zealand courts follow the English approach. This carries with it less uncertain implications on the drafting of large commercial contracts.

5.2 Paciocco

As a continuation of the same proceedings in *Andrews*, *Paciocco*'s appeal also concerns whether late payment fees imposed by ANZ Bank are penalties at law or in equity, and hence invalid. At first instance, Justice Gordon (now a High Court Justice) held that the fees were penalties, however, the Full Federal Court unanimously overturned this decision.

There were numerous issues in dispute, but the two issues relevant to construction contracts are:

- what is the relevance of the rules of remoteness of damage in determining whether a late payment fee clause is a penalty or genuine pre-estimate of damage; and
- in inquiring whether a stipulated sum is a penalty, what is the relevance of the process undertaken by the parties to fix the stipulated sum, and what evidence can be taken into account?

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[41] *Cavendish* [2015] UKSC 67, 22-3 [42] (Lords Neuberger and Sumption).

[42] Cf. *Cavendish* [2015] UKSC 67, 7 [13] (Lords Neuberger and Sumption).

[43] [2013] NZHC 3242 [5 December 2013], [117] (Mallon J). Note that although the New Zealand High Court in *Torchlight Fund No. 1 LP (In Receivership) v Johnstone* [2015] NZHC 2559 followed the *Andrews* approach, this was because the contract in that case was governed by New South Wales law.

In light of their Honours' recent judgment, I would like to spend a few moments analysing these issues and sharing some thoughts on the possible implications of this decision and what this means for the construction context.

Before doing so however, it is worth noting that the Court reaffirmed its previous holding in *Andrews*. In his judgment, Chief Justice French noted that although convergence is generally preferable to divergence in comparative law, the common law of Australia is distinct from that of the UK, and disagreement does exist.[44] Thus, it seems unlikely that the position in Australia will return to its pre-Andrews position.

Remoteness of Damage

On the remoteness of damage question, the traditional *Dunlop* approach is to ask whether the agreed amount of damages is out of all proportion to the loss suffered by the aggrieved party. However, in this context, does the word 'loss' refer to losses recoverable at common law, or to all loss in general?

In *Cavendish*, the Court took the latter approach. This is because in looking to the legitimate interests being protected by the contract, the Court expressed a willingness to look beyond losses that are compensable at common law. Although the *Cavendish* Court noted that in many cases, the legitimate interests will accord with ordinary compensation, in some cases they may not, and construction contracts could well be one of those cases. This is because, as mentioned earlier, many major public sector construction projects are not designed for profit alone but rather have a broader public interest objective.

In *Paciocco*, the Australian High Court took a similarly broad approach and focused on the interests of ANZ being protected by the imposition of a late payment fee. Justice Gageler equated this inquiry to asking whether the stipulation has some purpose other than to punish. Thus, the majority held that the loss provision costs and regulatory capital costs incurred by ANZ could be taken into account when conducting the penalties inquiry, even though those costs would not be recoverable at common law.[45] As a result, the Court rejected the notion that the penalties doctrine was further enlarged by the rules of remoteness.

Justice Gageler explained why this is the case by reference to Lord Diplock's judgment in *Robophone*.[46] In that case, his Lordship noted that the basis for the enhanced loss under the 'second rule' in *Hadley v Baxendale* is the implied undertaking of the plaintiff to bear it. But this undertaking need not be implied. If the defendant is expressly informed by virtue of a liquidated damages clause that the plaintiff's loss in the event of a particular breach will be $X, and the defendant undertakes to accept this, the clause is enforceable whether or not those damages would ordinarily be recoverable.

The logical consequence of the judgments in *Paciocco* is that a liquidated damages clause can protect interests that extend beyond those ordinarily recoverable. Thus, the parties to a construction contract can seek to protect the broader policy interests they have in that project. *Paccioco* therefore is a favourable development from the perspective of the construction world, and signals a greater deference to the agreement of the parties.

Process of Agreement

In *Paciocco*, ANZ Bank admitted that it did not set the fee by reference to any process of estimation of the likely damage caused by a breach. Indeed, ANZ's argument largely focussed on the nature of the costs that could be taken into account as being likely to be incurred as a result of a late payment event, not the construction of the clause. As such, the Court's judgment did not discuss the relevance of evidence showing how the liquidated damages clause was arrived at.

Nevertheless, in future judgments it would be helpful to see an affirmation of the relevance of evidence showing the process of *how* the liquidated damages figure was reached. As a matter of policy and freedom of contract, if two large, commercial and legally represented parties have engaged in detailed discussions and reached an agreed amount, that should be taken into account in considering whether the

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[44] *Paciocco* [2016] HCA 28, [6]-[10] (French CJ).

[45] *Paciocco* [2016] HCA 28, [65] (Kiefel J; French CJ agreeing), [170]-[171] (Gageler J), [283] (Keane J).

[46] *Paciocco* [2016] HCA 28, [163] (Gageler J).

clause is a penalty.[47] This is because the two parties involved are often in a better position than anyone else to understand, approximate and bargain for, the losses that non-compliance could cause.

To facilitate this, the courts might take a broad approach to the evidence admissible in analysing this process. This should be permissible as the court will not be engaged in an exercise of interpreting the contract, *per se*, but rather in an exercise of seeing whether the clause, properly interpreted, is a penalty in *all the circumstances* available to both parties. In saying so, there is no need to conclude on the validity of a clause merely by reference to the difference between the penalty amount and the actual losses conceived. The Court would instead be considering whether the parties had negotiated and considered the likelihood of the type of damage that has arisen, and together with the legitimate interest test, decide on the validity of the clause.

In addition to such developments, there are aspects of the common law that are deficient in addressing the unique issues associated with a construction project. In light of this, I turn now to the civil law, where a particularly liberal approach is taken to the doctrine of penalties, in which some value can be discerned.

6. Civil Law

The operation of the doctrine of penalties differs substantially between common law and civil law jurisdictions. There are two crucial distinctions to be made:

1. Civil law countries presume the enforceability of penalty clauses as a valid means of compelling performance. There is therefore little distinction made between penalty clauses and liquidated damages clauses;[48] and

2. Courts and Arbitrators applying civil law have the authority to adjust or proportion an amount stipulated as a penalty. As I have mentioned, the Courts in most common law jurisdictions do not have this power.

6.1 History

An initial word of caution. As with common law jurisdictions there is a significant variation in detail between the law of civil law jurisdictions both as to the code provisions and the approach to interpretation of particular provisions. Further the overlay of administrative law on the enforceability of government contracts cannot be ignored. Therefore the comments that follow must thus be qualified.

As a brief history, the enforceability of penalty clauses in civil law stems from modern civil codes having their roots in the Napoleonic Code of 1804, itself a product of earlier Roman law, and in particular the 6th century Justinian Code.[49] Roman Law operated under the principle of literal enforcement, where Courts would enforce any type of penalty clause without mitigation.[50] This principle saw codification in the Napoleonic Code, which was subsequently spread throughout Continental Europe during the years of the Napoleonic Wars.[51]

Many countries have, over time, progressively abandoned this strict literal enforcement approach and have made provisions for civil courts and decision-makers to review and adjust the amount stipulated under a penalty clause in certain circumstances. A leading catalyst for this development came in 1971 from the Council of Europe, which issued a "Resolution on Penalty Clauses" with the aim of unifying the

[47] See also *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* [2014] VSCA 32, [54] the Victorian Court of Appeal said: 'In a case like this involving commercial organisations of apparently equal bargaining power, courts should be prepared to allow a substantially larger degree of latitude than would be appropriate in case of a contract of adhesion'.

[48] Antonio Pinto Monteiro, 'Dictionary/Dictionnaire/Lexikon' (2001) 9(1) *European Review of Private Law* 149,149.

[49] Robert B. Holtman, *The Napoleonic Revolution* (Louisiana State University Press, 1981).

[50] Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civil Tradition*, (Oxford University Press, 1990).

[51] Holtman, above n 34.

application of penalty clauses for member states. The resolution maintains the presumption in favour of penalty clauses, but allowed the amount stipulated to be reduced if the Courts found that it was manifestly excessive or if part performance of the contract had occurred.[52]

To guide determinations of whether a penalty clause is "manifestly excessive", the explanatory memorandum to the Council of Europe's Resolution provides a list of factors to consider. These include the comparison of the pre-estimated damages to the actual harm, the legitimate interest of the parties, the industry relevant to the contract, the circumstances in which it was concluded, the position of the parties, and even whether the penalty was made in good or bad faith.[53]

With this historical context, I move now to the modern operation of the penalties doctrine in civil jurisdictions.

6.2 Operation

The Napoleonic Code currently the "French" Civil Code, will frame much of my discussion of the civil law approach to the penalty doctrine. Many other jurisdictions have similar laws, and therefore this analysis is relevant to the broader civil law world.

A penalty clause is referred to as a "clause pénale" under French law and is defined in Article 1226 of the Civil Code to be "a clause by which a person, in order to ensure performance of an agreement, binds himself to something in case of non-performance". A generalist description, the Article requires only that a party bind themselves to an agreement of payment in the event of breach. Importantly, despite the nomenclature "penalty clause", the clauses this section describes covers what the common law world would consider to be both liquidated damages clauses and penalty clauses.

The subsequent Articles 1227 to 1229 collectively indicate that a penalty clause acts as an alternative to non-performance, and that the remedy in the event of non-performance is either an order for specific performance, or an enforcement of the penalty clause. It is only in the case of delay that a party can seek both the performance of the principal, and the penalty clause itself.[54]

Relevant for our discussion, however, is the flexibility inherent in the civil law approach. French courts are given authority to adjust the amount of a penalty clause under Article 1152 in the event that the amount "is obviously excessive or ridiculously low". Although a common law lawyer would criticise this as the Courts now modifying the bargain between the parties, this approach might alternatively be understood as the Court honouring the parties' agreement to the maximum possible extent permitted by the law and public policy. Such an approach would be more deferential to the agreement of the parties providing for a liquidated damages clause.

Further, in practice, French Courts objectively approach this situation by using, in addition to the factors listed in the Council of Europe's Resolution, the contract price and actual loss as a basis for the amount of the penalties award, and they rarely award an amount greater than 5% of the contract price.[55] Indeed, a recent French Court of Cassation ruling made clear that an innocent party cannot claim more than the damages the penalty clause would address without first demonstrating the existence of specific damages outside the scope of the penalty clause.[56]

Another opportunity to adjust the amount of a penalty clause presents itself where part performance has occurred. Article 1231 allows the court to adjust the penalty clause with consideration for the interest that the part performance has procured for the innocent party.

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[52] Resolution 78(3) of the Committee of Ministers of the Council of Europe; Relating to Penal Clauses in Civil Law.

[53] Larry A. DiMatteo, 'A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages' (2008) 38(4) *American Business Law Journal* 633, 653.

[54] Article 1229 of the *French Civil Code*; NB: notice is required under Article 1230.

[55] Laurent Karila and Matthew E. Vincigeurra, 'The Civil law Concept of Penalties and the Common Law Concept of Liquidated Damages' (2014) 2(10) Insight from Hindsight 1, 2 <http://www.navigant.com/~/media/WWW/Site/Page/Insights/IFH/2014/CON_IH_CivilLawConceptOfPenalties_TL_0414%20-%20Final.ashx>.

[56] Cass. 3e civ., 23 October 2012, n° 11-19602, 1255, *Bull*.

Similar definitions, provisions and operations of the doctrine of penalties can be found all across civil code countries, for example Italy,[57] Spain,[58] Germany,[59] the Netherlands,[60] Switzerland,[61] Belgium,[62] China,[63] and Russia.[64]

Turning to the Middle East, however, in Bahrain liquidated damages are not permitted in the absence of loss suffered, and may be reduced if the amount fixed was grossly exaggerated.[65] In the UAE, the position is cast even more broadly; the Court is granted power to vary any agreement upon the application of a party so as to make the compensation equal the loss.[66]

In a construction context, it is unlikely that an applicant would be able to prove the absence of loss, and therefore the general inquiry will surround whether the agreed damages are grossly exaggerated, or do not match the loss. In assessing this, the Court must look at the *actual losses* suffered, not whether the agreed amount was grossly exaggerated at the time of entry into the contract. However, the Court should also recognise that such clauses are finely balanced in the entire scheme of a large project transaction, and should therefore require cogent evidence before overturning such an agreement.

Holistically, upon reflection, some parts of the civil law experience would appear to be ill-suited to our common law system. An example is the ability to compare a liquidated damages clause to the actual losses suffered. Such a step adds an element of retrospectivity to an agreement that was previously concluded on permissible terms, and increases uncertainty about a parties' true liabilities and obligations.

Nevertheless, the common law system would do well to take some lessons from our civil law counterparts, in particular, the option to modify and adjust the rate at which liquidated damages are levied, as opposed to the rejection of the clause outright. The broad range of stakeholder interests in large-scale public and private construction projects means that although some delay losses are compensable by the general law (despite being difficult to prove), others such as community disadvantage are not.

Liquidated damages clauses offer the ability to cover these unique risks that stem from different stakeholders, and there are therefore serious policy considerations to consider in ensuring these clauses are routinely enforced. The common law strict rejection of penalty clauses is an approach which often leads to arbitrary and inequitable outcomes. An injured party is then forced to overcome evidentiary issues in claiming general damages, as well as remaining uncompensated for unique losses that the general law does not recognise. For these reasons, the penalty doctrine as it stands is, in my view, less than satisfactory, particularly in the context of carefully negotiated construction agreements formulated to address the unique interests of the contracting parties.

Concerns relating to undermining freedom of contract can be mitigated by the fact that any modification of the liquidated damages amount would be based on an objective test, having consideration for the

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[57] Article 1382 of the *Codice Civile* entitles the use of penalty clauses; Article 1384 of the *Codice Civile* allows Courts to reduce the penalty amount if it is "manifestly excessive" or in the event of part performance.

[58] Articles 1152 and 1153 of the *Código Civil* presume in favour of penalty clauses; Article 1154 of the *Código Civil* provides judges with an ability to reduce the amount in the event of part performance, but not if the amount is excessive.

[59] Articles 340 and 341 of the *Bürgerliches Gesetzbuch (BGB)* allows for the enforcement of penalties in the event of non-performance and improper performance; Article 343 of the *BGB* allows for the reduction of the penalty amount if it is "disproportionately high" with consideration for "every legitimate interest of the obligee, not merely financial".

[60] Article 6:94 of the *Dutch Civil Code* allows adjustments of penalty clauses if required "by the standards of reasonableness and fairness".

[61] Article 163(3) of the *Code de Obligation Suisse* allows mitigation of penalty clauses that are "excessive".

[62] Article 1231 of the *Code Civil* presumes in favour of penalty clauses and allows mitigation where it "obviously exceeds the actual damage" and in the event of part performance.

[63] Article 114 of the *Contract Law of the People's Republic of China* presumes in favour of liquidated damages and allows the adjustment of the penalty amount higher or lower in proportion to the actual loss.

[64] Article 330 of the *Civil Code of the Russian Federation* presumes in favour of penalty clauses and Article 333 allows reduction of the penalty amount if it is "obviously out of proportion" to the actual losses.

[65] Article 226 of the *Bahrain Civil Code*.

[66] Article 390(2) of the *UAE Civil Transactions Law*.

surrounding circumstances of the contract. The scope of this remedy, therefore, would remain limited and would apply only in exceptional circumstances. An analogy is the approach common law courts often take to statutory interpretation. If a provision lacks constitutional validity, it will be inoperative *to the extent* of that invalidity. A similar principle would see a liquidated damages clause be unenforceable *to the extent* that it is a penalty, but with a broader view of recognising the legitimate interests protected by a penalty clause.

7. Concluding Remarks

So, to bring tonight's lecture back to the title; where to from here?

The historical development of the doctrine of penalties is a tale of the protectionist position of the courts; the courts will always and rightly protect parties whose unequal bargaining power has been abused to their disadvantage. However, in modern construction contracts, at least, this scenario appears less often than would justify court intervention, and no doubt where courts do intervene, an injured party risks coming out more injured than when it entered.

Thus, in an industry where uncertainty is rife, it is important for courts to champion flexibility in their analysis of the bargains of commercial parties. From a practical viewpoint, it is only through flexibility that the needs of construction contracts, in which each project is unique, and rarely are the same participants, stakeholders and risks involved, will be adequately addressed.

In my opinion, the recognition of legitimate interests in *Cavendish* was a step in the right direction and a legal victory for the construction world. The recent decision of *Paciocco* in affirming the relevance of non-common law losses in this inquiry furthered this progress. It would in my view be desirable for courts of New Zealand and Australia to build on these decisions and to adopt their principles domestically. That is not to say, however, that *Cavendish* and *Paciocco* represent the most ideal approach for construction parties. Taking relevant lessons from India as well as the civil code countries, the ability of the Court to adjust liquidated damages and award reasonable compensation instead of merely striking down "penal' provisions is certainly worth considering for construction industry participants.

In these times where we see penalty clauses challenged in the highest courts of a number of countries, it is important for construction industry participants to enter the debate and on that note, I thank you for the opportunity to offer my contribution to this discussion.