Singapore Journal of Legal Studies
[2018] 104–127

PENALTY CLAUSES: LESSONS FROM AUSTRALIA AND ENGLAND AND POSSIBLE LEGISLATIVE REFORMS

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The law on penalty clauses has, until recently, remained largely unchanged, with only minor developments over the years. However, there have been significant developments in both Australia and England and Wales in recent times. Singapore's position on the penalty rule has remained unchanged despite these developments. While some High Court authorities in Singapore have suggested that they are inclined towards adopting the developments seen in England and Wales, such a step should only be taken after careful consideration of the implications of these developments which are explored in this article. This article takes the opportunity to examine and evaluate the law on penalty clauses in various jurisdictions and discusses the key issues surrounding the law on penalty clauses, and the possible legislative reforms for Singapore.

I. INTRODUCTION

The law on penalty clauses (the "penalty rule") has, until recently, remained largely unchanged since *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*,[1] with only minor developments over the years. However, there have been significant developments in both Australia and England and Wales ("England") in recent times, brought about by the cases of *Andrews v Australia and New Zealand Banking Group Ltd*,[2] *Paciocco v Australia and New Zealand Banking Group Ltd*[3] and *Cavendish Square Holding BV v Makdessi; ParkingEye Ltd v Beavis*.[4] Singapore's position on the penalty rule has remained unchanged despite these developments, as seen in *Xia Zhengyan v Geng Chanqing*.[5] While some High Court authorities[6] in Singapore have

* LLB (Hons), National University of Singapore. I would like to thank my mentor, Associate Professor Sandra Annette Booysen for her comments and assistance for this article. I would also like to thank Miss Carmen Lim, my former colleague who collaborated with me on part of the preliminary work for this article. All views expressed in this article are my own and do not reflect the views of any organisation I am affiliated with. All errors remain my own.

1 [1915] AC 79 (HL) [*Dunlop*].

2 (2012) 247 CLR 205 (HCA) [*Andrews*].

3 (2016) 333 ALR 569 (HCA) [*Paciocco*].

4 [2015] UKSC 67 [*Cavendish*]; [*ParkingEye*].

5 [2015] 3 SLR 732 (CA) [*Xia Zhengyan*].

6 See *eg*, *iTronic Holdings Pte Ltd v Tan Swee Leon* [2016] SGHC 77 at paras 164-179; *Allplus Holdings Pte Ltd v Phoon Wui Nyen (Pan Weiyuan)* [2016] SGHC 144 at paras 15-40; *CIFG Special Assets Capital I Ltd v Polimet Pte Ltd* [2017] SGHC 22 at paras 124-127; and *Leiman, Ricardo v Noble Resources Ltd* [2018] SGHC 166 at paras 196, 197, 212-215.

suggested that they are inclined towards adopting the developments in *Cavendish*, such a step should only be taken after careful consideration of the implications of these developments, which are explored in this article.

This article begins in Part II with a discussion of the penalty rule set out in *Dunlop*, the recent developments in Australia and England, the significance, problems and implications of these developments, and finally Singapore's current position. Part III examines the theoretical basis of the penalty rule, and whether it should be abolished. Part IV discusses the scope of the penalty rule, *ie* when the rule applies (the "jurisdiction question"), a question which Australia and England differed significantly in their approach. Part V analyses the new "legitimate interest" test which determines whether a contractual term is penal (the "validity question"). Part VI considers the consequences of a contractual term being found penal (the "effect question"). Part VII then looks at some residual issues. Before concluding, Part VIII discusses the possible legislative reforms to the penalty rule.

II. The Penalty Rule and Recent Developments

A. *Dunlop and its Problems*

The penalty rule under *Dunlop* is that a contractual term, which imposes a detriment amounting to a punishment for a breach of contract on the party in breach ("promisor"), is generally unenforceable. Subsequent cases have held that while the detriment imposed is usually payment of a sum of money, it can also include obligations to transfer property[7] and the innocent party's ("promisee") right to withhold monies payable to the promisor.[8]

Dunlop's approach for the jurisdiction question is that the penalty rule only applies to contractual terms which impose a detriment for breach of contract,[9] *ie* secondary obligations.[10] For the validity question, the test[11] to determine whether a contractual term is penal is whether the detriment imposed is a genuine pre-estimate of the damage arising from the breach, or if it is unconscionable, imposed *in terrorem* of the promisor. This is a matter of construction, and is determined at the time of entry into the contract, having regard to the inherent circumstances at that point. The comparison is made between the detriment imposed, and the greatest recoverable loss arising from the breach that is conceivable at the time of entry into the contract.[12] The actual loss suffered is also relevant, where it illustrates whether the detriment imposed is a genuine pre-estimate or if it is unconscionable.[13] Finally, for the effect question,

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7 See *eg*, *Jobson v Johnson* [1989] 1 WLR 1026 (CA) and *E C Investment Holding Pte Ltd v Ridout Residence Pte Ltd* [2011] 2 SLR 232 (HC) [*E C Investment*].

8 See *eg*, *Modern Engineering (Bristol) Ltd v Gilbert-Ash (Northern) Ltd* [1974] AC 689 at 698D-F, 703G, 711D, 723H (HL) [*Gilbert-Ash*].

9 See *eg*, *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 (HL) and *Stansfield Business International Pte Ltd (trading as Stansfield School of Business) v Vithya Sri Sumathis* [1998] 3 SLR(R) 927 (HC) [*Stansfield*].

10 See also *Cavendish*, *supra* note 4 at paras 13, 14.

11 *Dunlop*, *supra* note 1 at 86-88.

12 *Ibid*.

13 *Philips Hong Kong Ltd v The Attorney General of Hong Kong* [1993] 61 BLR 41 at 59 (PC) [*Philips Hong Kong Ltd*].

there were some cases suggesting that a penalty clause is not unenforceable, but enforced to the extent of the losses recoverable in court for breach of contract.[14] However, the weight of authority indicates that such clauses are completely unenforceable,[15] and parties will have to prove their loss in the ordinary way, subject to rules of causation and remoteness, *etc*.

The penalty rule based on *Dunlop* has, however, become increasingly criticised. First, as it applies only to secondary obligations, it is easily evaded by drafting.[16] The false dichotomy and difficulty in determining whether a detriment imposed by a contractual term is a genuine pre-estimate of damage or is unconscionable is another common criticism.[17] Finally, the court's lack of discretion to award a lower or higher sum where a contractual term is found to be penal is also problematic. Indeed, the penalty rule has arguably not weathered well over the years,[18] and the courts had to improvise by introducing a "commercial justification" exception to address these criticisms. This exception applied where a contractual term, although not a genuine pre-estimate of the damage suffered, is nevertheless enforceable if commercially justified.[19] Nonetheless, many of these problems remain unresolved, and this means that the penalty rule based on *Dunlop* remains problematic. However, due to path dependence, substantial judicial reform did not seem forthcoming. There were thus calls in England and Scotland, by their respective law commissions, for legislation to resolve these problems. Their suggestions will be discussed below, in Part VIII.

B. *Recent Developments*

1. *Australia*

(a) *Introduction*: In Australia, the development of the penalty rule began first in *Andrews*, and later in *Paciocco*. For the jurisdiction question, *Andrews* recognised that there was a subsisting equitable jurisdiction to the penalty rule ("equitable jurisdiction"). Since it applied historically to conditional defeasible penal bonds where the "conditions" imposed were not always contractual obligations, the equitable jurisdiction did not apply only to secondary obligations—a requirement that remains applicable under the common law jurisdiction of the rule.[20] Thus, the equitable jurisdiction may apply to contractual terms which impose a detriment for a failure of a "condition" which is not a breach of contract. The equitable jurisdiction as stated by *Andrews*, however, does not apply to contractual terms which are alternative stipulations, *eg* fees payable for additional services.[21] Furthermore, the penalty rule

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14 *Supra* note 7 at 1042, 1045, 1046.

15 See *eg*, *Cavendish*, *supra* note 4 at para 9.

16 *Ibid* at para 14. See also *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433 [*Interfoto*] for Lord Bingham's introduction of the concept of "disguised penalties".

17 *Cavendish*, *ibid* at paras 31, 145, 152. See also *Cine Bes Filmcilik VE Yapimcilik AS v United International Pictures* [2004] 1 CLC 401 at para 15 (CA).

18 *Cavendish*, *ibid* at para 3.

19 See *eg*, *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752 at 763G-764A.

20 *Andrews*, *supra* note 2 at paras 39, 42, 45, 78. See also *eg*, Robert Stevens, "Rights Restricting Remedies" in Andrew Robertson & Michael Tilbury, eds, *Divergences in Private Law* (Oxford: Hart Publishing, 2016) 159 at 173, 174.

21 *Andrews*, *ibid* at paras 79-83.

does not apply, where the damage to the interests of the promisee is insusceptible of assessment in money terms.[22]

Next, for the validity question, *Andrews* also decided that whether a contractual term is penal is determined by whether the detriment imposed is commensurate with the promisee's interest protected by the bargain.[23] This is based on Lord Atkinson's judgment in *Dunlop*.[24] This aspect of *Andrews* may have attracted far less attention, as seen in *Paciocco v Australia and New Zealand Banking Group Ltd*,[25] where Gordon J continued to apply Lord Dunedin's test,[26] and it was only in *Paciocco v Australia and New Zealand Banking Group Ltd*[27] and *Paciocco* where the judges confirmed that this was the applicable test, under both the common law and equitable jurisdiction of the penalty rule.[28]

Finally, *Andrews* also established that the effect of a penalty clause is that it is *enforceable*, but only to the extent of compensating the promisee of the damage to his interest in the performance of the contract by the promisor.[29] This appears to be so under both the common law and equitable jurisdiction of the penalty rule, as seen in *Paciocco FCA*[30] and *Paciocco FCAFC*.[31] *Andrews* has thus overruled previous authorities establishing that a contractual term found to be penal is unenforceable.[32]

(b) *Facts and decision of* Andrews *and* Paciocco: The facts of *Andrews* and *Paciocco* are largely similar. In both cases, the plaintiffs, as applicants of representative proceedings under Part IVA of the *Federal Court of Australia Act 1976*[33] complained that the various fees charged by Australia and New Zealand Banking Group, pursuant to the terms of the contract between the bank and its customers were unenforceable penalties and in breach of various statutory provisions. The claims for breach of these statutory provisions are not relevant to our discussion and will not be discussed. The High Court of Australia ("HCA") in *Andrews* did not, however, decide whether the contractual terms allowing the bank to charge the various fees were unenforceable penalties—this question was remitted back to the Federal Court of Australia ("FCA").

In *Paciocco*, by a majority of four to one, the HCA affirmed *Paciocco FCAFC* that the contractual terms allowing the bank to charge late payment fees were not penalties.[34] The late payment fees were payable upon the customer's failure to pay on time, and any delay in payment was a breach of contract. Therefore, the penalty rule was applicable under both the common law and the equitable jurisdiction.[35] In

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22 *Ibid* at para 11.
23 *Ibid* at para 75.
24 *Ibid*. See also *Dunlop*, *supra* note 1 at 91-93.
25 [2014] FCA 35 [*Paciocco FCA*].
26 *Ibid* at para 15.
27 [2015] FCAFC 50 [*Paciocco FCAFC*].
28 See *Paciocco*, *supra* note 3 at paras 2, 69, 176, 271-274, 278 and *Paciocco FCAFC* at para 103.
29 *Andrews*, *supra* note 2 at para 10.
30 *Supra* note 25 at para 13.
31 *Supra* note 27 at para 27.
32 See *eg*, Sirko Harder, "The Scope of the Rule Against Contractual Penalties: A New Divergence" in Andrew Robertson & Michael Tilbury, eds, *Divergences in Private Law* (Oxford: Hart Publishing, 2016) 135 at 142, 147 [Harder, "The Scope of the Rule Against Contractual Penalties"].
33 (Cth), Part IVA.
34 *Paciocco*, *supra* note 3 at paras 2, 68, 69, 176, 219, 265, 267, 271-274.
35 *Ibid* at para 7.

determining the validity of the late payment fees, the court considered if the detriment imposed was commensurate with the bank's interest in having its customers pay on time.[36] The majority found that the bank had legitimate interests in receiving timeous repayment, since its financial interest was impacted by any late payment arising from operational costs, loss provisioning and increases in regulatory costs.[37] It also had a commercial interest in rewarding itself for the financial risks it assumed in providing credit[38] and in removing uncertainty and expense of litigation through the use of a contractual provision.[39] The late payment fees were thus not out of all proportion to the bank's legitimate interest,[40] or imposed with a punitive purpose.[41] Nettle J, dissenting, held that the contractual terms allowing the bank to impose late payment fees were straightforward damages clauses,[42] and the bank's only legitimate interest was repayment of the sums owed with interest and any costs in fact incurred or reasonably conceived at the time of entry into the contract for late payment.[43] Thus, he found that the late payment fees imposed were unconscionable when compared to the greatest loss that could conceivably be proved to have followed from the breach, and were penalties.[44]

2. *England*

(a) *Introduction*: The key developments in the penalty rule in England are found in *Cavendish* and *ParkingEye*. The United Kingdom Supreme Court ("UKSC") rejected calls to abolish the penalty rule, citing reasons such as its long existence, the presence of similar rules in other jurisdictions, and the need to protect contracting parties from penalty clauses even with legislation protecting consumers.[45] It also declined to follow Australia's approach and expand the scope of the penalty rule. Instead, it criticised *Andrews*, stating that it was difficult to apply and contrary to freedom of contract and precedents.[46] It disagreed principally with the Australian position that the equitable jurisdiction had subsisted, believing that this is historically inaccurate.[47] However, it confirmed that the penalty rule applied to detriments imposed on breach ranging from payment of sums of money, transfer of property,[48] withholding of monies payable by the promisee to the promisor,[49] and also extended it to forfeiture clauses involving deposits and other interests, but not instalments.[50]

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36 *Ibid* at paras 52, 142, 270.
37 *Ibid* at paras 58, 173, 176.
38 *Ibid* at paras 216, 277, 278.
39 *Ibid* at paras 176, 283.
40 *Ibid* at para 68.
41 *Ibid* at paras 176, 283.
42 *Ibid* at paras 333, 334.
43 *Ibid* at para 323.
44 *Ibid* at para 370.
45 *Cavendish*, *supra* note 4 at paras 38, 167, 260.
46 *Ibid* at para 42.
47 *Ibid* at paras 37, 162-167, 263. *Cf* James Allsop, "The Doctrine of Penalties in Modern Contract Law" (2018) 30 Sing Ac LJ 1 at 12, which asserted that both versions of history may be valid (at paras 29, 30).
48 *Cavendish*, *ibid* at paras 16, 157-159, 230-233.
49 *Ibid* at paras 73, 154-156, 226-228.
50 *Ibid* at paras 16, 160, 161, 234-238.

For the jurisdiction question, the UKSC confirmed that the penalty rule applies only to contractual terms which are secondary obligations.[51] Secondary obligations are defined as those seeking to measure and compensate damages arising from breach of contract, as an alternative to damages at law.[52] The penalty rule thus does not apply to primary obligations, including conditional primary obligations.[53] This is even when the condition in the conditional primary obligation involves a breach of contract. This is considered novel,[54] and further narrows the jurisdiction of the penalty rule.[55] For the validity question, the UKSC abolished Lord Dunedin's test in *Dunlop* by clarifying that it was intended only as a guideline.[56] The true test is whether the detriment imposed is out of all proportion,[57] or unconscionable,[58] when compared to the interest the promisee has in the performance of the contractual obligation by the promisor. This, again, is based on Lord Atkinson's judgment in *Dunlop*. Finally, for the effect question, the UKSC confirmed that the effect of a penalty clause is that it is wholly unenforceable.[59] It rejected the Australian approach, as the court is likely to take on the role of rewriting the contract as between the parties, which it was ill-suited to do.[60]

(b) *Facts and decision of* Cavendish *and* ParkingEye: The facts of *Cavendish* are that Makdessi agreed to sell his controlling stake in the holding company of an advertising and marketing communications group to Cavendish Square Holding BV under an agreement, which was extensively negotiated by lawyers. Payments were to be made in four instalments and the purchase price included a goodwill element. These payments were subject to Clause 11.2 which required Makdessi not to compete, employ any senior employee, or solicit or divert away trade from the group, until two years after he had ceased employment with the group. If this clause were breached, under Clause 5.1, Makdessi would not receive the last instalments of the purchase price, and under Clause 5.6, he could be required to sell his remaining shares at a price which excluded goodwill. Makdessi breached his obligations under Clause 11.2 and argued that Clause 5.1 and 5.6 were unenforceable penalties. Separately, in *ParkingEye*, ParkingEye was the car park manager of Riverside Retail Park that provided free parking to motorists for two hours. However, if they failed to leave within the duration, a parking charge of £85 was imposed under a term displayed at the entrance of the car park. Beavis overstayed and when ParkingEye demanded payment of the parking charge, he argued that it was an unenforceable penalty.

In both cases, the UKSC held that the contractual terms complained of were not unenforceable penalties. In *Cavendish*, the court held that for Clause 5.1, Cavendish had a legitimate interest in ensuring that the price it paid reflected the value of the

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51 *Ibid* at paras 14, 32, 239, 241.
52 *Ibid* at paras 74, 241.
53 *Ibid* at para 14.
54 See *eg*, Lord Justice Christopher Clarke, "Changing Course at the Top" (2017) 29 Sing Ac LJ 23 at 33-36.
55 See *eg*, Andrew Summers, "Unresolved Issues in the Law on Penalties" (2017) LMCLQ 95 at 102, 105.
56 *Supra* note 4 at para 22.
57 *Ibid* at para 32.
58 *Ibid* at paras 152, 255.
59 *Ibid* at paras 9, 87, 255.
60 *Ibid* at para 87.

company being purchased, which had been significantly based on its goodwill, and this was dependent on Makdessi's observance of Clause 11.2.[61] For Clause 5.6, the same legitimate interest existed to ensure that the price of the remaining shares which Makdessi held reflected the value of the company being purchased, which again included goodwill and depended on Makdessi's observance of Clause 11.2.[62] For both clauses, the court did not think that the detriment imposed under the clauses were "out of all proportion" or "unconscionable".[63] Interestingly, in *Cavendish*, it was unclear[64] if there had been a clear majority as to the nature of Clauses 5.1 and 5.6, although arguably, a majority did hold that both clauses were secondary obligations.[65] Therefore, the penalty rule was applicable.[66] In *ParkingEye*, the UKSC found that ParkingEye had a legitimate interest in managing the car park scheme to prevent overstaying and to generate income.[67] The parking charge was not "out of all proportion" or "unconscionable" as it was comparable to charges imposed by local authorities for overstaying at public car parks, and other private car park operators.[68]

C. *Problems*

The main concerns in Australia are that the equitable jurisdiction is a dramatic expansion of the scope of the penalty rule.[69] While it is perhaps historically justified, there were no explanations why the equitable jurisdiction should be resurrected a century later.[70] Furthermore, as the equitable jurisdiction does not apply to alternative stipulations, the penalty rule may still be evaded via drafting.[71] In England, the same concerns of artificiality have also surfaced, since the decision in *Cavendish* confirmed the position that the penalty rule applied only to secondary obligations, and thus drafting out of the penalty rule remains possible. Furthermore, by holding that conditional primary clauses—even when the condition is a breach of contract—did not fall within the jurisdiction of the penalty rule, its scope has become extremely narrow, and the rule is arguably moribund.[72]

Additionally, the "new" test in both Australia and England, based on the promisee's legitimate interest in performance of the contract by the promisor, and whether the detriment imposed is commensurate, or unconscionable to that legitimate interest, raises many questions. First, it is unclear what constitutes a "legitimate interest",[73]

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61 *Ibid* at paras 75, 274, 282.

62 *Ibid* at para 82.

63 *Ibid* at paras 78, 88, 181, 185, 278, 282.

64 See *eg*, Goh Yihan & Yip Man, "English Reformulation of the Penalty Rule: Relevance in Singapore?" (2017) 29 Sing Ac LJ 257 at 265 and Allsop, *supra* note 47 at 19, 21 (at paras 51, 52, 57).

65 Clarke, "Changing Course at the Top", *supra* note 54 at 34, 35.

66 *Ibid*.

67 *Cavendish*, *supra* note 4 at paras 99, 199, 286.

68 *Ibid* at paras 100, 107, 287.

69 *Ibid* at para 42. See also Harder, "The Scope of the Rule Against Contractual Penalties", *supra* note 32 at 140, 141 and JW Carter *et al*, "Contractual Penalties: Resurrecting the Equitable Jurisdiction" (2013) 30 J Contract L 99 at 101, 132 [Carter, "Contractual Penalties"].

70 Harder, "The Scope of the Rule Against Contractual Penalties", *ibid* at 140, 141.

71 *Ibid* at 150. See also Carter, "Contractual Penalties", *supra* note 69 at 125.

72 Clarke, "Changing Course at the Top", *supra* note 54 at 32.

73 Carmine Conte, "The Penalty Rule Revisited" (2016) 132 Law Q Rev 382 at 387.

even though the UKSC cautioned that it will take a principled approach.[74] Indeed, in *Paciocco*, the majority readily found that ANZ had legitimate interests in requiring its customers to pay on time. Next, it is also not clear how the court undertakes the evaluative exercise of determining whether the detriment imposed is commensurate or unconscionable.[75] In *ParkingEye*, it was possible to compare the detriment imposed against other similar schemes,[76] but this may not always be possible. *Cavendish* also held that Lord Dunedin's test in *Dunlop* remains applicable for "straightforward liquidated damages clauses",[77] but there is little guidance as to what such clauses are, and how to apply Lord Dunedin's test, especially when it has been "dismantled" by *Cavendish*.[78]

Also, although *Cavendish* disagreed with *Andrews* on the effect of a penalty clause, both decisions have been criticised. For example, with respect to *Andrews*, it is unclear how "compensation" can be available if the "condition" is not a breach of contract.[79] Also, if the clause is enforced to the extent that the compensation is commensurate with the interest the promisee has in the performance of the contract, it raises the problems of the court rewriting the contract for the parties.[80] For *Cavendish*, as it reaffirmed that a penalty clause is unenforceable, this means that the court has no discretion to provide a just solution to the parties, and only common law damages are recoverable.

Finally, some miscellaneous issues continue to trouble the penalty rule even after these developments. For example, another criticism in relation to the Australian development of the penalty rule is that the impossibility of evaluating the compensation available should not exclude the applicability of the equitable jurisdiction, but should instead be merely a consideration as to whether the detriment imposed was commensurate with the interest the promisee has.[81] For the English development, another problem is that while the court stated that the penalty rule cannot be evaded simply by form, and it will examine the substance of the contractual term (*eg* disguised penalties), it provided little guidance on what constitutes a penalty clause in substance.[82]

D. *Practical Effect*

The consensus appears to be that drafting remains crucial despite these developments.[83] Thus, to evade the penalty rule, it is crucial to draft any contractual term

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74 *Cavendish*, *supra* note 4 at para 39.

75 *Supra* note 73.

76 *Cavendish*, *supra* note 4 at paras 100, 287.

77 *Ibid* at para 32.

78 JW Carter *et al*, "Assessment of Contractual Penalties: Dunlop Deflated" (2017) 34:1 J Contract L 4 at 18-30.

79 *Cavendish*, *supra* note 4 at para 42.

80 *Ibid* at paras 86, 87.

81 Carter, "Contractual Penalties", *supra* note 69 at 122.

82 *Summers*, *supra* note 55 at 98.

83 See *eg*, Fay Fong & Tay Yong Seng, "Singapore High Court finds clause in settlement agreement to be a penalty and unenforceable" (30 August 2016), online: <http://www.allenandgledhill.com/pages/publications.aspx?list=LBulletinAreas&pub_id=1193&view=d>.

that seeks to impose a detriment outside of the ambit of a secondary obligation (in England) or a collateral stipulation (in Australia) and instead, as a primary obligation, or an alternative stipulation respectively.[84] This should exclude the application of the penalty rule entirely. Next, due to the shift to the "legitimate interests" test, it may be desirable to state the interests of the parties in the preamble or recitals of the contract, to provide a clear indication of the legitimate interests of the parties.

E. *Singapore's Position*

Singapore's position on the penalty rule can be seen from a series of cases[85] largely affirming Lord Dunedin's test in *Dunlop*.[86] In essence, the penalty rule applies only to secondary obligations, and the test is whether the detriment imposed was unconscionable, imposed *in terrorem* of the party in breach, or a genuine pre-estimate of damage.[87] A contractual term found to be penal is unenforceable.[88] The penalty rule applies to detriments imposed for breach requiring payment of money, and for transfer of property.[89] However, it does not apply for "true deposits".[90]

The "commercial justification" exception was previously thought to be applicable in Singapore.[91] However, the Singapore High Court ("SGHC") in *Pun Serge v Joy Head Investments Ltd*[92] held, contrary to *stare decisis*, that it did not apply. Theoretically, this development should mean that courts would face problems dealing with contractual terms which are neither genuine pre-estimates of damage, nor imposed *in terrorem* of the promisor. However, such problems have yet to surface. Nevertheless, since *Cavendish*, some High Court authorities have suggested that *Cavendish* may be followed, such that the penalty rule only applies to secondary obligations and the "legitimate interest" test will be adopted.[93] It remains to be seen if *Cavendish* will be followed.

III. Theoretical Basis of the Penalty Rule and its Abolition

A. *Theoretical Basis*

In general, there are three main theoretical bases of the penalty rule that are commonly discussed: to prevent punishment, ensure consistency with the compensation principle, and finally, prevent unconscionability. All three of them complement each other,

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84 *Ibid*.

85 See *eg*, *Hong Leong Finance Ltd v Tan Gin Huay* [1999] SGCA 18 [*Hong Leong Finance*]; *CLAAS Medical Centre v Ng Boon Ching* [2010] SGCA 3; and *Xia Zhengyan*, *supra* note 5.

86 *Xia Zhengyan*, *ibid* at para 78.

87 See *Stansfield*, *supra* note 9 at paras 9, 18.

88 *Hong Leong Finance*, *supra* note 85 at para 27.

89 See *E C Investment*, *supra* note 7 at paras 125, 129.

90 See *eg*, *Lee Chee Wei v Tan Hor Peow Victor* [2007] SGCA 22 at paras 83, 84 and *Hon Chin Kong v Yip Fook Mun* [2017] SGHC 286 at paras 123, 130, 143.

91 *Supra* note 85 at paras 25, 26.

92 [2010] 4 SLR 478 at paras 42-45 (HC).

93 *Supra* note 6.

although the theoretical basis of unconscionability arguably explains the normative basis of the rule best.[94]

The first theoretical basis of the penalty rule is that it prevents contracting parties from punishing each other.[95] The idea is that contract law cannot be utilised to punish the contracting parties.[96] However, this theoretical basis does not explain what constitutes a punishment,[97] and simply asserts that contracting parties cannot punish each other. It is thus an inadequate theoretical basis on its own for the penalty rule.

Another theoretical basis for the penalty rule is to ensure consistency with the compensatory principle.[98] This means that parties cannot agree to remedies that are inconsistent with their recoverable losses in court.[99] This is true, but this basis suffers from several inconsistencies with the penalty rule. First, the compensatory principle requires determination of the recoverable damages at the time of breach, unlike the penalty rule, where the validity of the contractual term alleged to be penal is traditionally determined at the time of entry into the contract, based on the greatest conceivable loss at that point.[100] Next, a legitimate liquidated damages clause is enforceable whether it falls short or exceeds the actual recoverable damages, and parties are given a wide margin of error, such that it can no longer be said to be truly *compensatory* in nature.[101] Furthermore, it is inconsistent with the recent developments in Australia and England, since courts in both jurisdictions recognised precisely that there may be interests beyond compensation which parties can contract for.[102] Indeed, in these cases, the promisees did not suffer any loss.[103]

The last theoretical basis for the penalty rule is that of unconscionability,[104] where the penalty rule is seen as part of the piecemeal approach the common law has towards controlling unconscionable contractual terms.[105] In the context of penalty clauses, this is where the detriment imposed is so *disproportionate* to the damage to the legitimate interest of the promisee that it is oppressive and unfair to the promisor, and is further elaborated below in Part V. This justifies why in determining whether a contractual term is penal, it is achieved by comparing the detriment imposed and the legitimate interest of the promisee, rather than the recoverable loss in court (as it is not concerned with the compensatory principle), and whether it is unconscionable, consistent with recent developments. Therefore, unconscionability is the

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94 See Allsop, *supra* note 47 at 15, 23 (at paras 37, 67), suggesting that the heart of the doctrine was "extravagance and unconscionability".

95 *Cavendish*, *supra* note 4 at paras 32, 243. See also *PH Hydraulics & Engineering Pte Ltd v Airtrust (Hong Kong) Ltd* [2017] SGCA 26 at paras 72, 73, 76 [*Airtrust*].

96 *Ibid*.

97 See Mindy Chen-Wishart, "Controlling the Power to Agree Damages" in Peter Birks, ed, *Wrongs and Remedies in the Twenty-First Century* (Oxford: Oxford University Press, 2006) 280.

98 *Ibid*.

99 *Andrews*, *supra* note 2 at para 44. See also *Cavendish*, *supra* note 4 at para 131 and Allsop, *supra* note 47 at para 73.

100 Chen-Wishart, "Controlling the Power to Agree Damages", *supra* note 97 at 277, 278.

101 *Ibid*.

102 *Cavendish*, *supra* note 4 at paras 32, 152.

103 *Ibid* at paras 184, 285.

104 See *eg*, *supra* note 97 at 283.

105 *Interfoto*, *supra* note 16 at 445, 446.

basis which best explains the recent developments, and provides a normative basis for the penalty rule. While some people may be uncomfortable with the concept of unconscionability due to its uncertainty, the Singapore Court of Appeal ("SGCA") has, in another context, stated that unconscionability can be applied in a principled manner.[106] Thus, while all three theoretical bases complement each other to justify the penalty rule, the first two offer less explanatory value. In contrast, unconscionability explains the penalty rule best.[107] Hence, in formulating the penalty rule, it is argued that its theoretical and normative foundation in unconscionability should be respected.

B. *Abolition*

The penalty rule is seen to be contrary to party autonomy[108] and disrupts the certainty required in commercial contracts.[109] It is also economically inefficient,[110] in that an overly broad scope of the penalty rule prevents protection of idiosyncratic valuation of performance of the contractual obligations and results in under-compensation for the innocent party, especially where he had provided more consideration to protect his idiosyncratic valuation.[111] On the other hand, an overly narrow scope of the penalty rule (*ie* more contractual terms found to be enforceable) can result in the prevention of efficient breach by contracting parties.[112] Thus, it is unsurprising that there have been calls to abolish it.[113]

Nonetheless, the key to resolving these issues lie in achieving a balance in giving effect to freedom of contract, while also recognising that it is not absolute, and must give way to concerns of fairness, especially if the practice of contracting is to be protected. To protect all forms of contractual bargains, including unconscionable ones may erode the practice of contracting since people may lose confidence in it.[114] Thus, the penalty rule remains relevant and should not be abolished.

IV. The Scope of the Penalty Rule

A. *Only Secondary Obligations?*

The penalty rule applies only to secondary obligations. However, it is questionable whether this restriction is necessary. First, it is difficult to distinguish between primary and secondary obligations. Indeed, in *Cavendish*, the court disagreed as to

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106 *BS Mount Sophia v Join-Aim* [2012] SGCA 28 at paras 37, 38 [*BS Mount Sophia*].

107 *Supra* note 94.

108 Sarah Worthington, "Common Law Values: The Role of Party Autonomy in Private Law" in Andrew Robertson and Michael Tilbury, eds, *The Common Law of Obligations* (Oxford: Hart Publishing, 2016) 301 at 317-322.

109 *Cavendish*, *supra* note 4 at para 33.

110 Goetz and Scott, "Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach" (1977) 77 Colum L Rev 554 at 557, 574, 592 and 593.

111 *Supra* note 97 at 275.

112 *Supra* note 110 at 562.

113 *Cavendish*, *supra* note 4 at paras 36, 126, 216.

114 See Mindy Chen-Wishart, *Contract Law*, 5th ed (Oxford: Oxford University Press, 2015) at 27.

whether Clauses 5.1 and 5.6 were primary obligations, although it appears that a majority did view them as secondary obligations.[115] There is also no justification for distinguishing between them, since both are part of the contractual bargain. A higher contractual price (primary obligation) could also have been agreed so as to obtain the protection found in the secondary obligation alleged to be penal.[116] To cherry-pick only the secondary obligation will mean a failure to account for the overall contractual bargain.

This restriction to secondary obligations is thought to be necessary as a safeguard against the court's excessive jurisdiction over contractual bargains.[117] It is justified based on freedom of contract and to ensure commercial certainty.[118] Yet, these considerations are overplayed, and arguably irrelevant. Indeed, lessons may be drawn from the law on exception clauses. Exception clauses may be compared to penalty clauses in situations involving breaches of contract, since both are secondary obligations, except that the former often seeks to limit or exclude liability for the party in breach, whereas the latter seeks to amplify liability for the party in breach in such situations. The application of the *Unfair Contract Terms Act*[119] [*UCTA*] to exception clauses has not undermined commercial certainty, and its applicability is not restricted to "defensive" limitation clauses only (*ie* those operating on breach), but rather substance is examined over form.[120]

If the objection is that the jurisdiction over exception clauses is granted by the *UCTA*, and that the common law has traditionally refrained from such intervention, then the objection can easily be overcome by departing from such illogical path dependence, and to develop the common law consistent with legislation and its policy. Indeed, as Lord Diplock stated:

> Where over a period of years there can be discerned a steady trend in legislation which reflects the view of successive Parliaments as to what the public interest demands in a particular field of law, development of the common law in that part of the same field which has been left to it ought to proceed upon a parallel rather than a diverging course.[121]

Thus, it is difficult to support a restriction of the penalty rule to only secondary obligations, especially in light of the *UCTA* or even the *Consumer Protection (Fair Trading) Act*,[122] which empower the court to review the substantive fairness of contractual terms without any restrictions. Therefore, it is proposed that *Cavendish* should not be followed in this aspect. Nonetheless, since several decisions by the SGHC[123] have indicated their willingness to follow *Cavendish*, the next section will examine how this can be done.

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115 Clarke, "Changing Course at the Top", *supra* note 54 at 34, 35.
116 Chen-Wishart, "Controlling the Power to Agree Damages", *supra* note 97 at 273-275.
117 Goh & Yip, *supra* note 64 at 270.
118 *Cavendish*, *supra* note 4 at para 43.
119 Cap 396, 1994 Rev Ed Sing.
120 See *eg*, *Deutsche Bank AG v Chang Tse Wen* [2013] SGCA 49 at para 68.
121 See *Erven Warnick Besloten Vennootschap v J. Townend & Sons (Hull) Ltd* [1979] AC 731 at 743 (HL).
122 Cap 52A, 2009 Rev Ed Sing.
123 *Supra* note 6.

B. *Following* Cavendish

It is arguably more consistent with precedents to follow *Cavendish*, and restrict the applicability of the penalty rule to secondary obligations, albeit also considering the substance of the contractual term, rather than just its form.[124] However, while the courts often state that it will consider substance over form, the problem is that it has always done the opposite instead.[125] This problem must be overcome, before we can then consider how a court can hold that a contractual term is a disguised penalty.

It is unclear how a court can determine whether a contractual term is in substance a penalty.[126] There are a few possibilities. First, this can be based on whether the contractual term is a sham, in the sense that while it appears to be a primary obligation, it is in fact a secondary obligation. This will require the court to determine "the actual legal rights and obligations which the parties intend to create",[127] but it is inconsistent with *Cavendish* which stated that the application of the penalty rule may still turn on drafting.[128] Another possibility may simply be based on contextual interpretation, in which the concept of disguised penalty is incorporated. The process will be based on the rules of interpretation set out in *Zurich Insurance (Singapore) Pte Ltd v B-Gold Interior Design & Construction Pte Ltd*,[129] the inherent circumstances of the contract,[130] and where pre-contractual negotiations and subsequent conduct may also be relevant to shed light on what the parties truly intended in relation to the nature of the obligation (primary or secondary), provided they satisfy the requirements of *Zurich Insurance*[131] and *Sembcorp Marine Ltd v PPL Holdings Pte Ltd*,[132] and that they are used in a confirmatory rather than pivotal role.[133] Another string to the bow in the process of interpretation is that where there is doubt as to whether a contractual term is in substance a secondary obligation, we can rely on *contra proferentum* such that any ambiguity is resolved against the party who drafted the clause, and if not, the party seeking to rely on the clause.[134]

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124 *Cavendish*, *supra* note 4 at paras 15, 39, 43, 258.

125 See Harder, "The Scope of the Rule Against Contractual Penalties", *supra* note 32 at 151.

126 See *eg*, Summers, *supra* note 55 at 96, 98, 99, and William Day, "A Pyrrhic Victory for the Doctrine against Penalties: *Makdessi v Cavendish Square Holding BV*" (2016) 2 J Bus L 115 at 122.

127 See *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 at 802.

128 See *Cavendish*, *supra* note 4 at para 43. See also *supra* note 55 at 99.

129 [2008] SGCA 27 at para 132 [*Zurich Insurance*].

130 See *Xia Zhengyan*, *supra* note 5 at para 78.

131 *Supra* note 129 at para 132(d).

132 [2013] SGCA 43 at paras 73, 74 [*Sembcorp*].

133 *Supra* note 5 at para 68.

134 See *eg*, *LTT Global Consultants v BMC Academy Pte Ltd* [2011] SGHC 80 at paras 56-59. However, consider also the argument as seen in Sirko Harder, "The Relevance of Breach to the Applicability of the Rule against Penalties" (2013) 30 J Contract L 52 at 56, where he observed that the application of *contra proferentum*, in relation to the ambiguity of whether the promisee undertook to prevent the occurrence of the event triggering the alleged penalty clause, will mean that the promisee will be presumed not to have given the undertaking, and therefore, since the alleged penalty clause does not operate on breach, the penalty rule does not apply, and thus, *contra proferentum* operates unfavourably for the promisee.

C. *Following Australia*

The other question is whether an equitable jurisdiction should be recognised, just as in Australia. The SGCA has previously recognised an equitable jurisdiction in common mistake and unilateral mistake, even if this was divergent from English law, as seen in *Chwee Kin Keong v Digilandmall.com Pte Ltd*[135] and *Olivine Capital Pte Ltd v Chia Chin Yan*.[136] This was to ameliorate the rigours of the common law and grant relief where justice so requires.[137]

Indeed, it can be argued that the Australian position should be followed because contrary to *Cavendish*, it accurately represents the historical position in equity.[138] The penalty rule had its origins in equity providing relief against the enforcement of the conditional defeasible penal bond and the conditions stipulated were not always obligations,[139] and thus, it need not involve any breach of contract. Thus, it was not necessary for there to be a breach of contract before relief could be provided under the equitable jurisdiction. Furthermore, while such penal bonds are no longer utilised, there exist some similarities with letters of credit and performance bonds that are used in modern commerce.[140] Singapore has seen interesting developments in the law on performance bonds, allowing relief from calls on performance bonds where the calls are unconscionable.[141] And while this has been criticised for being uncertain and unjustified,[142] it can now be justified as an example of the exercise of the equitable jurisdiction. Thus, if an equitable jurisdiction is recognised, this may be justified on the basis of these prior developments.

However, as rightly pointed out in *Cavendish*, there are also problems with the equitable jurisdiction as formulated by *Andrews* and *Paciocco*. The carve-out for alternative stipulations is likely to create familiar problems of artificiality by allowing contract drafters to evade the penalty rule.[143] These problems, however, could be overcome by the substance over form approach as discussed above. The other problem is that the equitable jurisdiction does not apply if the damage to the interest of the promisee is insusceptible of evaluation.[144] This is supposedly because it is the availability of compensation that "generates the equity" to relieve the promisor from the penalty clause.[145] This must be a very rare instance, since generally, it is not that the damage is incapable of evaluation, but rather evaluation will be difficult and inaccurate. More importantly, it is unclear why this should be so—the incapability of evaluation should be a consideration in whether the term is a penalty, rather than

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135 [2005] SGCA 2 at para 74 [*Chwee Kin Keong*].
136 [2014] SGCA 19 at para 69 [*Olivine Capital*].
137 *Supra* note 135 at paras 62, 74.
138 See *eg*, SM Waddams, *The Law of Contracts*, 7th ed (Toronto: Thomson Reuters, 2016) 316. See also Allsop, *supra* note 47 at 12 (at paras 29, 30).
139 See *eg*, Stevens, *supra* note 20 at 173, 174.
140 See *Andrews*, *supra* note 2 at footnote 4.
141 See *BS Mount Sophia*, *supra* note 106 at paras 18, 19.
142 *Ibid* at paras 32-35.
143 *Cavendish*, *supra* note 4 at para 42.
144 *Andrews*, *supra* note 2 at para 11.
145 *Ibid*.

a basis to exclude the penalty rule.[146] If the Australian approach is to be followed, this aspect ought to be reconsidered.

D. *Types of Detriment Imposed*

It is also important to consider the scope of the penalty rule in relation to the detriments imposed by the contractual term. The penalty rule is applicable where the detriment involves the payment of a sum of money. Other authorities have also confirmed that it applied to detriments requiring a transfer of property,[147] or allowing withholding of monies payable.[148] These are not controversial.

The application of the penalty rule to contractual terms allowing forfeiture is however, more controversial. *Cavendish* decided that the penalty rule can apply to contractual terms allowing for forfeiture of deposits.[149] Traditionally, the penalty rule did not apply to clauses allowing for forfeiture of true deposits, and only relief from forfeiture is available, which appears to be Singapore's current position.[150] Next, *Cavendish* was unclear on whether the penalty rule applied to contractual terms allowing for forfeiture of instalments (although a majority suggested that it could apply).[151] Additionally, it decided that for proprietary interest transferred which determined *(ie* terminated) or were revoked upon breach of contract, both the penalty rule and relief from forfeiture applied (although the minority did not appear to agree),[152] and that is so for all other cases involving forfeiture.[153] The justification that a contractual term can be subject to both the penalty rule and relief from forfeiture was that the former operated at the time of contracting and determined if a contractual term was unenforceable, while the latter depended on the circumstances at the time of breach, and is applicable only after a term has been found to not be penal. This meant that they "operated at different points with different effects".[154] This is quite convincing. However, it is unclear why there should be any distinction based on the type of property forfeited, such as between deposits and instalments.[155] One suggested reason is that deposits are payment for security, whereas instalments do not serve that function.[156] This is true, but unconvincing. It will be better if all of these detriments imposed are subject to the penalty rule, and this aspect of *Cavendish* has to be considered carefully before Singapore chooses to follow it, especially since cases

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146 Carter, "Contractual Penalties", *supra* note 69 at 122.

147 *Supra* note 7.

148 *Gilbert-Ash*, *supra* note 8.

149 *Cavendish*, *supra* note 4 at paras 16, 18, 160, 238.

150 *Supra* note 90.

151 *Cavendish*, *supra* note 4 at paras 16, 72 (Lords Sumption, Neuberger and Carnworth, holding that the penalty rule did not apply to forfeiting of instalments), but *cf* paras 156, 170, 229, 291, 294 (Lords Mance and Hodge reserving their views, and Toulson and Clarke assumed to agree).

152 *Ibid* at para 17 (Lords Sumption, Neuberger and Carnworth holding that the penalty rule did not apply), but *cf* paras 160, 161, 227, 291, 294 (Lords Mance, Hodge, Toulson and Clarke holding generally that it did).

153 *Ibid* at paras 160, 161, 227, 291, 294.

154 *Ibid*.

155 See *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130 at 146 (CA) [*Else*].

156 *Ibid*.

in Singapore have preferred to separate the jurisdiction of the penalty rule, and the jurisdiction in providing relief from forfeiture of true deposits.[157]

Another question is whether the penalty rule can apply to a contractual right to terminate where termination is otherwise not permitted by the common law,[158] *ie* the right to terminate being the detriment. The weight of authority suggests that it cannot be so, as the courts are anxious to protect the autonomy of the contracting parties, and the promisee's right of electing whether to terminate.[159] Nonetheless, this deserves further consideration, since the exercise of the right of termination can have oppressive consequences,[160] although this may be too radical.

Finally, we should also consider the interaction between contractual terms imposing penalties, and those imposing limitation or exclusion of liability, especially where it involves breach of contract. It is possible that the punishment imposed by the promisee on the promisor is that any rights the promisor has in relation to the promisee's breach of other contractual obligations is limited or excluded upon breach. In such a situation, the contractual term is possibly both a penalty and exclusion clause. It is thus subject to both the *UCTA* and the penalty rule, which impose separate tests of unreasonableness, and unconscionability respectively. While both tests are likely to yield similar results generally, in some cases unreasonableness need not amount to unconscionability. Does that mean that the contractual term will be unenforceable under the *UCTA* even if it is not penal? This appears to be so, although we should consider if there should be consistency in both regimes, especially since they have many similarities.

V. The Legitimate Interest Test

The applicable test to determine the validity of a contractual term alleged to be penal is the "legitimate interest test" in Australia and England. The legitimate interest test involves two stages: the court first determines if the promisee has a legitimate interest in the performance of the contractual obligation by the promisor, and then considers if the detriment imposed is unconscionable when compared to this legitimate interest.

A. *Legitimate Interest*

The concept of "legitimate interest" has increasingly become relied on as a control mechanism where a promisee is seeking a remedy that departs from the usual compensatory measure of damages. It is relied on in cases involving (a) damages based on the restitutionary measure,[161] (b) actions for agreed sum,[162] (c) specific

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157 *Supra* note 90.

158 See Louise Gullifer, "Agreed Remedies" in Andrew Burrows and Edwin Peel, eds, *Commercial Remedies: Current Issues and Problems* (Oxford: Oxford University Press, 2003) 191 at 202.

159 See *eg*, *Lombard North Central v Butterworth* [1987] QB 527 at 535, 536, 546 and *RDC Concrete Pte Ltd v Sato Kogyo (S) Pte Ltd* [2007] SGCA 39 at paras 91, 97.

160 *Supra* note 158 at 202.

161 See *eg*, *Attorney General v Blake* [2001] 1 AC 268 at 285, 287 (HL) [*Blake*].

162 See *eg*, *White and Carter (Councils) Ltd v McGregor* [1962] AC 413 at 431 (HL) [*White and Carter*], where Lord Reid stated that a party with no legitimate interest will not be allowed to claim the contract price.

performance or injunctive relief being sought,[163] (d) restraint of trade ("legitimate *proprietary* interest"),[164] and now for penalty clauses.

As pointed out in *Cavendish*, the promisee's legitimate interest can go beyond financial or compensatory considerations. Indeed, it may encapsulate almost anything.[165] The following have been found to be legitimate interests: maintaining a pricing structure of a product,[166] maintaining and protecting the goodwill of a business,[167] ensuring timely performance of obligations,[168] maintaining a scheme to ensure profitability and manage availability of resources,[169] ensuring performance of obligations even where no loss is suffered,[170] preventing the promisor from profiting from his breach,[171] protecting trade secrets, trade connections and maintaining a stable workforce,[172] *etc*.

Given the wide range of interest found to be legitimate, it is crucial that courts take a principled approach.[173] Indeed, they should not readily find that legitimate interests exist, and should instead clearly set out what the recognised legitimate interests are, and the classes of people that are recognised as possessing these interests. If legitimate interests can be readily established, then the promisee can abuse them and the courts will not be able to regulate contractual terms alleged to be penal. Indeed, *ParkingEye* is illustrative of this. The legitimate interest found there included community interests of the retailers (not contracting parties), and the promisee's legitimate interest in profiting from breach of contract by car park users (and not just legitimate interest in *performance* of the obligations).[174] Similarly, in *Paccioco*, the courts found that the bank had legitimate interest in making profits, even huge ones for its shareholders.[175] If these cases were correct, then there is essentially no control mechanism in identifying whether the promisee has a legitimate interest, since any interest could be legitimate. There must be a normative limit on what constitutes a legitimate interest.

Cavendish suggests that parties with equal bargaining power are best placed to determine if any interest is legitimate.[176] This is one relevant factor. It is proposed that that parties should also be presumed to have only an interest in compensation

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163 See *eg*, *supra* note 161 at 282 and *Tullett Prebon (Singapore) Ltd v Chua Leong Chuan Simon* [2005] SGHC 150 at para 9.

164 See *eg*, *Man Financial (S) Pte Ltd (formerly known as E D & F Man International (S) Pte Ltd) v Wong Bark Chuan David* [2007] SGCA 53 at para 79 [*Man Financial*].

165 See *Turf Club Auto Emporium Pte Ltd v Yeo Boon Hua* [2018] SGCA 44 at para 253, where the SGCA commented that the concept of "legitimate interest" referred to in *Blake* and *White and Carter* is general and perhaps even vague.

166 *Dunlop*, *supra* note 1 at 92.

167 *Cavendish*, *supra* note 4 at paras 75, 81, 82, 274, 278, 282.

168 *Paciocco*, *supra* note 3 at paras 58, 69, 271.

169 *ParkingEye*, *supra* note 4 at paras 99, 199, 286. See also *Paciocco*, *ibid* at paras 216, 277, 278 on having a legitimate interest in making huge profits.

170 *Blake*, *supra* note 161 at 282. See also *Cavendish*, *supra* note 4 at paras 28, 30, 32, 99, 145, 152, where the court recognised that there was a legitimate interest beyond compensation for any loss suffered.

171 *Blake*, *ibid* at 285, 287.

172 *Man Financial*, *supra* note 164 at paras 94, 121.

173 *Cavendish*, *supra* note 4 at para 39.

174 *ParkingEye*, *supra* note 4 at paras 98, 99, 193, 196. See also Summers, *supra* note 55 at 112, 113.

175 *Paciocco*, *supra* note 3 at paras 216, 277, 278.

176 *Cavendish*, *supra* note 4 at para 35.

for the greatest recoverable losses that can be conceived at the point of contract, and only exceptionally, other legitimate interests are recognised, especially where it is clear that both parties agreed to it. With an incremental approach in developing what constitutes legitimate interests from previous cases, this will enable the concept of "legitimate interest" to serve as a useful control mechanism.

B. *Unconscionability*

The courts then consider whether the detriment imposed is unconscionable, in comparison to the promisee's legitimate interest. This is also problematic. Where there is a market comparison for the detriment imposed, such as in *ParkingEye*,[177] then this may be easier, although it is not conclusive of whether the detriment imposed is unconscionable.[178] But it is more difficult where there is no market comparison. Indeed, in *Cavendish*, it appears that once the court found that Cavendish had a legitimate interest in preserving the goodwill of the company it was seeking to purchase, unless there had been any evidence to the contrary (although the UKSC did not elaborate on what constitutes such evidence), the detriment imposed was not unconscionable.[179] This meant that once a legitimate interest was recognised, no evaluation or balancing was done unless there was evidence to the contrary.[180] While this may be consistent with the burden of proof, since the promisor alleging that the term is penal has to furnish evidence, coupled with the problem of the courts readily finding the existence of legitimate interest of the promisee, this renders the legitimate interest test perfunctory, and the penalty rule applies in such exceptional circumstances that it is next to impossible to establish.[181]

Thus, it is critical that the courts undertake an evaluative approach when applying the legitimate interest test. Some guidelines were indeed given in *Cavendish*, where the court suggested that it will examine the equality of bargaining power of the contracting parties and if they have been legally advised,[182] whether there is reasonable notice of the term alleged to be penal,[183] and whether there has been knowledge of the promisee's legitimate interest,[184] before deciding if the detriment imposed was unconscionable in comparison to the promisee's legitimate interest.

However, the balancing approach undertaken should also be based on the overarching theme of unconscionability, arguably the main theoretical basis of the penalty rule. As mentioned above, the detriment imposed on the promisor is unconscionable where it is so disproportionate to the damage to the legitimate interest of the promisee that it is oppressive and unfair. The starting point to determine unconscionability should thus be whether there is any procedural unconscionability, *eg* abuse of

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177 *ParkingEye*, *supra* note 4 at paras 96, 100, 287.
178 *Ibid* at para 196.
179 See *eg*, *Cavendish*, *supra* note 4 at para 77.
180 See Conte, *supra* note 73 at 387.
181 *Ibid*. See also Clarke, "Changing Course at the Top", *supra* note 54 at 32, where Lord Justice Clarke described the penalty rule as moribund.
182 *Cavendish*, *supra* note 4 at paras 35, 75, 282. See also Goh & Yip, *supra* note 64 at 261.
183 *Cavendish*, *ibid* at paras 100, 287; Goh & Yip, *ibid* at 261.
184 Goh & Yip, *ibid* at 261.

bargaining power, since procedural unconscionability is often indicative of substantive unconscionability. This is consistent with *Cavendish* and *ParkingEye*'s approach, where bargaining power and reasonable notice played a key role in the decisions. Other related considerations in relation to procedural unconscionability include: absence of bargaining, presence of any lack of comprehensibility, assessability, negotiability and unfair surprise experienced by the promisor.[185]

The courts should then go on to consider various factors indicative of substantive unconscionability, such as the type of contract (especially standard form contracts), the price or premium paid by the promisee for the benefit of the alleged penalty clause (assessed holistically), the extent of failure of consideration or degree of breach by the promisor which resulted in the operation of the alleged penalty clause, the degree of disproportionality between the detriment imposed and the damage to the legitimate interest of the promisee, especially where there is manifest unfairness, and finally, the impact of the term on the promisor.[186] With this suggested approach towards evaluating the detriment imposed on the promisor against the legitimate interest of the promisee, this should address concerns that the courts do not engage in any balancing exercise at all once a legitimate interest is found, and prevent the penalty rule from becoming perfunctory. It will also reflect the overarching theme of unconscionability that forms the basis of the penalty rule.

VI. The Effect Question

Under the common law, contractual terms found to be penal are generally unenforceable. Therefore, the conclusion reached in *Cavendish* is not entirely controversial, although in Australia, the position is that the penalty clause is enforced only to the extent of compensating the promisee's damage to his interest in the performance of the contract by the promisor. It has also become increasingly recognised that this all-or-nothing approach[187] can indeed be overly harsh and prone to injustice. Thus, it may be better if some discretion is left for the courts,[188] although any discretionary approach allowing the court to award a reasonable amount is likely to require legislative intervention,[189] and will be discussed below in Part VIII.

The other possibility is to adopt the approach in Australia, where the contractual term is enforced, but only to the extent that it compensates the promisee for the damage to his legitimate interest and nothing further. However, it was pointed out that this will involve the court rewriting the contract, which it is not equipped to do.[190] There is certainly some merit to this objection, as the court is ignoring the detriment

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185 Chen-Wishart, "Controlling the Power to Agree Damages", *supra* note 97 at 290.

186 *Ibid* at 295-298.

187 *Else*, *supra* note 155 at 144.

188 For *eg*, in *Ting Siew May v Boon Lay Choo* [2014] SGCA 28, the courts held that in relation to contracts entered into with the object of committing an illegal act, it will no longer be automatically unenforceable, but rather subject to the court's discretion, where it undertakes a balancing approach to decide if the contract should be rendered wholly unenforceable. However, it will appear that such a discretion will not change the fact that it remains all or nothing, as the court, if it exercises such discretion in favour of the promisee, will then enforce the penalty clause in full.

189 *Supra* note 155 at 144.

190 *Cavendish*, *supra* note 4 at para 87.

imposed that was agreed between the contracting parties, and is seeking to determine the damage to the promisee's legitimate interest independently, which need not be based on losses suffered arising from any breach.[191] The court's determination of the value of the damage to the promisee's legitimate interest may therefore be seen as rewriting the contract, and is similar to the concept of "notional severance", which has not been well-received in Singapore.[192] Thus, it is not clear if the Australian position should be followed in this aspect.

VII. Residual Issues

An unresolved issue is that of "cumulative penalties", where contractual terms provide for separate consequences or detriments arising from the same breach, which may not be penal individually, but when read together can be so.[193] A court should definitely consider such cumulative effect in determining if the penalty rule applies, and this must be so to prevent contracting parties from evading the penalty rule by setting out different consequences or detriment for the same breach of contract in separate contractual terms.[194] Furthermore, since the question of whether a contractual term is penal is resolved based on contractual interpretation, the entire contract and its cumulative effect should be considered.[195]

Another unresolved issue is whether in the event that the actual damage to the promisee's legitimate interest exceeds the detriment imposed, the promisee may allege that the contractual term is penal and thus unenforceable and claim recoverable damages instead. There are some authorities suggesting that this is possible,[196] especially since the question of whether a contractual term is penal is determined at the point of entering into the contract. However, this position will mean that the promisee, which had sought to punish the promisor via the contractual term initially, is placed in a better position, and it is arguably unfair. The other possibility is that the promisee is limited to only recovering the sum stipulated in the contractual term. This position is consistent with established authorities that actual damage can still be relevant[197] in determining whether the detriment imposed is a penalty. Thus, after taking that into account, it lends towards the interpretation that the contractual term is not penal, and the promisee will be required to claim for the agreed amount. The answer to this issue is unclear, but the better position will be this latter position, even though the limited authorities seem to point more towards the former position.[198]

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191 See *eg*, *ParkingEye*, *supra* note 4, where no loss was suffered. Note that if the penalty clause is enforced to compensate only losses suffered as a result of the breach by the promisor, which will presumably be based on recoverable damages, then there is arguably not much difference with the effect that the penalty clause is unenforceable, and the promisee is restricted to only recoverable losses. However, this is not so under the Australian approach.

192 See *eg*, *Lek Gwek Noi v Humming Flowers & Gifts Pte Ltd* [2014] SGHC 64 at para 179.

193 Goh & Yip, *supra* note 64 at 280.

194 *Ibid*.

195 See *Zurich Insurance*, *supra* note 129 at para 131, especially in relation to the "holistic" or "whole contract" approach.

196 *Wall v Rederiaktiebolaget Luggude* [1915] 3 KB 66 at 74.

197 *Philips Hong Kong Ltd*, *supra* note 13 at 59.

198 Edwin Peel, *The Law of Contract*, 14th ed (London: Sweet & Maxwell, 2015) at 20-141.

VIII. Reforms

Despite the developments in England and Australia, there are still problems with the penalty rule. Thus, there is still scope for reform to the penalty rule. However, as the penalty rule was developed by the courts, it is restricted by its path dependence. Any court, bound by its precedents, may find it difficult to depart radically from the established position. This is arguably why judges in both *Cavendish*[199] and *Paciocco*[200] have suggested that legislative reform may be necessary to eradicate the inherent problems of the penalty rule.

Indeed, there have been calls for legislative reforms to the penalty rule since the 1970s in England,[201] but little has been done. Nonetheless, if legislative reform to the penalty rule is forthcoming in Singapore, then Parliament can consider some of the approaches undertaken in other jurisdictions set out below, and the recommendations by the law commissions from England and Scotland.

A. *India and Malaysia*

In India, there is no distinction between liquidated damages clauses and penalty clauses[202] and both are governed by s 74 of the *Indian Contract Act, 1872*.[203] The same provision is found in Malaysia, under s 75 of the *Contracts Act 1950*.[204] Under this provision, where there has been a breach, if the contract contains any stipulation by way of penalty, the promisee is entitled, whether or not actual damage or loss is proved, to receive from the promisor reasonable compensation not exceeding the amount stipulated. The provision also applies to clauses stipulating for forfeiture of land where there has been a breach, although it does not apply to true deposits.[205] Further, it only applies to contractual stipulations imposing detriments where there *has been a breach*. Generally, in interpreting whether a stipulation is penal, the court considers various factors, such as the nature of the transaction, the relative situation of the parties, the rights and obligations accruing from the transaction and the parties' intentions in relation to the particular stipulation.[206]

This is a significant improvement over the common law position on the effect of a penalty clause, as it provides a wide discretion for the court to award a reasonable sum to the promisor. It is also arguably an improvement over the approach in equity, as the penalty clause can only be enforced to the extent of compensating the promisee of the damage to his interest, and this is more limited than the wide discretion that is provided by the provision. However, since the provision applies only to terms which

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199 *Paciocco*, *supra* note 4 at para 43.

200 *Andrews*, *supra* note 3 at para 10.

201 UK, The Law Commission, *Penalty Clauses and Forfeiture of Monies Paid* (Working Paper No 61) (London: Her Majesty's Stationary Office, 1975) [UK Law Commission, "Penalty Clauses and Forfeiture of Monies Paid"].

202 See *Bhai Panna Singh v Bhai Arjun Singh* AIR 1929 PC 179. See also David Hay, *Halsbury's Laws of India* (New Delhi: LexisNexis, 2002) vol 11 at 465 at para 95.139 [Halsbury's Laws of India].

203 (Act No 9, India).

204 (Act 136, Malaysia).

205 Halsbury's Laws of India, *supra* note 202 at 471 (para 95.141).

206 *Ibid* at 467 (at para 95.140).

operate upon breach of contract, it suffers from the same problem of possible evasion of the penalty rule via drafting. Thus, the main attraction of the provisions found in India and Malaysia is the discretion provided to the courts in relation to the effect of a penalty clause.

B. *France and Germany*

In Germany, the general position is that a contractual penalty, which is a penalty for non-fulfilment of contractual obligations, is enforceable.[207] However, if the penalty imposed is disproportionately high, it can be reduced to a reasonable amount on application to the court.[208] The power of reduction however, does not apply to contracts entered into between "merchants".[209] When exercising the power of reduction, the court considers the legitimate interest of the promisee, and not merely his financial interest.[210] It may also consider the interest of the promisor, including his degree of fault, his financial situation, and any benefits obtained by him from the breach.[211] However, where the amount stipulated has been paid, it is not possible to reduce the amount.[212]

For France, a contractual penalty is a clause which binds a person to do something (including provision of compensation), to ensure performance of an agreement,[213] and it is generally enforceable.[214] Under the *French Civil Code*, where an agreement provides for the payment of a certain sum as damages on failure to perform by the promisor, the promisee may not be awarded a greater or lesser sum.[215] While they are generally enforceable, a judge *may*, "even on his own motion" reduce or increase the agreed penalty where it is *manifestly* excessive or *ridiculously* low.[216] The court generally considers factors such as the inequality of bargaining power, economic situation and good faith of the promisor, and even his state of health.[217] Where there has been partial performance by the promisor, the contractual penalty may also be lessened by the judge in proportion to the benefit obtained by promisee, without prejudice to the power of reduction.[218] It is thus possible for a contractual penalty to be reduced first for being manifestly excessive, and then reduced further for part performance.

The statutory provisions in Germany and France suffer from familiar problems, where penalty clauses are defined as contractual terms that operates by imposing a penalty for a breach of contract. This means that it is possible to rely on drafting to

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207 See *German Civil Code BGB* (Germany), s 339.
208 *Ibid*, s 343.
209 See *German Commercial Code HGB* (Germany), s 348.
210 *Supra* note 207, s 343.
211 *Ibid*.
212 *Ibid*.
213 See arts 1231-1235 C civ (French Civil Code, in force since 1 October 2016). See also arts 1226, 1229, 1152 C civ (French Civil Code, pre-2016).
214 *Ibid*, arts 1231-1235.
215 *Ibid*.
216 *Ibid*.
217 See *eg*, Lucinda Miller, "Penalty Clauses in England and France: A Comparative Study" (2004) 53 ICLQ 79 at 91.
218 *Supra* note 213, arts 1231-1235.

evade these provisions, just as in the common law. Nonetheless, these provisions state clearly that the starting position is that all penal clauses are generally enforceable, while empowering the court with a discretion to reduce (or even increase) the amount payable, and allowing the courts to consider various factors and interests of both contracting parties when exercising this discretion. This again is a significant improvement over the common law position and the Australian position.

C. *South Africa*

Penalty clauses are governed by the *Conventional Penalties Act 1962*[219] in South Africa. The Act states that a penalty clause is "a stipulation whereby it is provided that any person shall, in respect of an act or omission in conflict with a contractual obligation, be liable to pay a sum of money or to deliver or perform anything for the benefit of any other person". This includes forfeiture clauses.[220]

Generally, all penalty stipulations are capable of being enforced, subject to the provisions of the Act. However, where the court finds that the penalty stipulation is out of proportion to the prejudice suffered by promisee, the court may reduce the penalty stipulated to such extent as it considers equitable. The court considers not only the proprietary interest of the promisee, but every other rightful interest affected in determining the prejudice suffered. Further, it is stated explicitly that a promisee cannot obtain both the benefit of the penalty and damages, and can only recover damages instead of the penalty where the contract provides for it.

Thus, the South African legislation is superior to the common law position, and the Australian position in relation to the effect of a penalty clause in largely similar ways as the other jurisdictions—that the courts are empowered under the provision to take into account various interests of the promisee when exercising their discretion to reduce the penalty. Interestingly, it also ensures that the promisee cannot recover both damages and the penalty, and cannot opt for damages over the penalty unless it has been contractually provided for. The South African legislation however, suffers from the same problem of envisioning only penalty clauses which operate on breach of contract, which means that drafting can evade the operation of the legislation.

D. *Law Commissions*

There have been proposed legislative reforms by law commissions in both England and Scotland. For the former, the most relevant is that the penalty rule should not be limited in its application to contractual terms which impose a detriment upon a breach of contract, but should include any contractual term for which its object is to secure the act or result which is the true purpose of the contract.[221] For the latter, it took a slightly different approach and recommended that in addition to contractual terms imposing a detriment for breach of contract, the jurisdiction of the penalty rule should include contractual terms imposing a detriment where there has been a failure

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[219] (S Afr), No 15 of 1962.

[220] *Ibid*, s 4. See also WA Joubert, *The Law of South Africa* (South Africa: Butterworth Publishers, 1994) vol 5 at 299.

[221] UK Law Commission, "Penalty Clauses and Forfeiture of Monies Paid", *supra* note 201 at para 26.

to perform (not amounting to breach) or where there has been early termination of the contract.[222] It also suggested that the penalty rule should be applied to whichever form of detriment imposed, which can include payment of monies, forfeiture of monies and property, and transfer of property.[223] Finally, it suggested that there were good arguments allowing for the courts to have power to modify a penalty.[224]

All of these suggested reforms are helpful, as they propose that the penalty rule be widened and not limited to only contractual terms imposing payment of sums of monies arising from breach. They are thus significant improvements over the common law position in relation to the jurisdiction question. Further, there are also proposals similar to the previous jurisdictions which confer the court a power or discretion to modify the penalty imposed which are also definitely better (as explained above) than the position in common law or equity.

IX. Conclusion

The penalty rule has remained largely unchanged for almost a century before undergoing significant developments in England and Australia in recent years, which has led to divergences in the two jurisdictions. This article has discussed the merits of the penalty rule and the recent developments, as well as the preferred position in relation to the three main aspects of the penalty rule, which relate to questions of jurisdiction of the penalty rule, validity, and effect of a contractual term found to be a penalty. It has also considered possible legislative reforms of the penalty rule from various jurisdictions and law reform commissions.

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222 Scottish Law Commission, *Discussion Paper on Penalty Clauses* (Discussion Paper No 103) (1997) at para 4.24.

223 *Ibid* at para 5.10.

224 *Ibid* at paras 5.46, 5.47.