

LECTURE ON LIQUIDATED DAMAGES CLAUSES

LIQUIDATED DAMAGES AND PENALTIES DEFINED

1. The rule against penalties is an exception to the general rule that the Court will enforce the terms of lawfully made contracts. The Court generally will not rewrite contracts or strike out clauses, which are unduly harsh.
2. The classic statement of the rule is in the House of Lords' decision in ***Dunlop Pneumatic Tyre Company v New Garage and Motor Company Ltd [1915] AC 79*** at pp 86 to 88:
 - "1. Though the parties to contract who use the words "penalty" or "liquidated damages" may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages...
 2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine pre-estimate of damage ...
 3. The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of the making of the contract, not at the time of the breach ...
 4. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:
 - (a) It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison to the greatest loss that could conceivably be proved to have followed from the breach...
 - (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid...
 - (c) There is a presumption (but no more) that it is a penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage"....On the other hand:
 - (d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damages was the true bargain between the parties ..."
3. A more contemporary statement of law is contained in the judgment of Colman J in ***Lordsdale Finance plc v Bank of Zambia [1996] QB 752*** at p 762G:

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

This statement has been approved by the Court of Appeal in *Murray v Leisureplay plc* [2005] IRLR 946.

4. There is a predisposition to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in commercial contracts. Where a liquidated damages clause has been made between parties of comparable bargaining power, negotiating at arms' length, the Court will be reluctant to strike down such a term, but this is not an abandonment of the rule that a clause must be a genuine pre-estimate of damage.
5. Commercial certainty of knowing the financial consequences of breach is desirable, particularly where loss will be hard to calculate. Liquidated damages clauses tend to avoid:
 - disputes
 - lengthy arguments
 - over complicated calculations
 - the risk of under compensating the innocent party.

ARE BANK CHARGES PENALTIES?

6. In April 2006, the Office of Fair Trading (“the OFT”) issued a position statement “Calculating fair default charges in credit card contracts”, in which they set £12 as threshold below which the OFT would not intervene in relation to default charges in credit card contracts. The OFT took the view that:
 - default charges were subject to the test of fairness under the Unfair Terms in Consumer Contracts Regulations 1999 (“the 1999 Regulations”);
 - a court would be likely to regard as unfair a default charge provision that enabled a credit card issuer to recover more than the damages which would be awarded at common law for breach of contract by the consumer; and
 - the default charge should reflect a reasonable pre-estimate of the net additional administrative costs occurring as a result of specific breaches of contract, which could be identified with reasonable precision.

Paragraph 5.14 stated:

“The broad principles set out in this statement are likely to be relevant to other default charges in standard agreements with consumers, such as those for mortgages, store cards and bank accounts. We expect the banks and other finance business to consider the wider implications of

these principles, and to bring any similar charges they impose for breach of contract into line with them, where and as appropriate bearing in mind the different legal and practical contexts in which they operate. If appropriate steps are not taken within a reasonable timescale, further regulatory investigation of the position can be expected.”

7. As is well known, tens of thousands of customers have sued banks for the recovery of default charges or made complaints to the Financial Ombudsman Service (“the FOS”). Usually, banks have filed a standard defence, but paid up on claims without admitting liability. There have been at least two cases in which the bank forgot to pay and did not attend a small claims hearing and district judges found in favour of the banks on the basis of their defences (eg ***Berwick and Haughton v Lloyds TSB Bank PLC [2007] CTLC 106***). These decisions were inadequate because the bank’s relevant contractual terms were not put before the Court.
8. In April 2007, the OFT launched an investigation into the fairness of personal current account unauthorised overdraft charges and returned item charges under the 1999 Regulations. At the same time, the OFT launched a wider enquiry into competition and value for money in the provision of personal current accounts.
9. In July 2007, the OFT entered into an agreement with seven banks, a building society and the Financial Services Authority (“the FSA”) to cooperate over a test case. Pursuant to that agreement, the OFT issued proceedings in the Commercial Court (the OFT v Abbey National plc and others, Claim No 2007 Folio 1186) against the banks and the building society, seeking a declaration that relevant terms and charges in personal current account agreements and tariffs to be in force as at 1st October 2007 and in a selection of earlier agreements fell to be assessed for fairness under the 1999 Regulations. Each of the defendants has counterclaimed for declarations under the 1999 Regulations and that the charges under its terms are not capable of amounting to a penalty at common law.
10. The banks have redrafted their terms and conditions in advance of the OFT case. For example, Lloyds TSB plc issued new personal banking terms and conditions as of 2.11.07, whereas previously the contract was regulated by common law and specific terms created in particular product or service documents. Among the changes are to refer to “unplanned overdrafts” rather than “unauthorised overdrafts” to highlight that a bank charge does not arise on breach of contract but as a payment for a service.
11. Following the issue of the OFT’s action, the FSA issued a waiver from its complaints handling rules that apply to unauthorised overdraft charges complaints until the OFT’s action is resolved or 12 months, whichever is earlier. This relieves banks of the requirement to handle complaints relating to unauthorised overdraft charges within the usual time limit of within 8 weeks of

receiving the complaint, although complaints must still be acknowledged within 5 days by banks. The FOS has suspended work on bank charge cases. County Court claims are being stayed if a defence is filed.

12. In the OFT case, the key provision is regulation 6(2) of the 1999 Regulations, which states:

“In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate:

- (a) to the definition of the main subject matter of the contract, or
- (b) to the adequacy of the price or remuneration, as against the goods or services supplied in exchange.”

The case advanced by the defendant banks and building society in essence is that:

- their terms and conditions are in plain intelligible language;
- regulation 6(2)(b) precludes the Court from assessing the fairness of bank charges, which (reading the regulation widely) are a price or remuneration for the services provided under the contract;
- regulation 6(2)(b) relates to the price or remuneration for any service provided by the bank, not just the price or remuneration for services that are the main subject matter of the bank/customer contract (ie regulations 6(2)(a) and 6(2)(b) have to be read disjunctively);
- an unauthorised/unplanned overdraft is not a breach of contract, but an implied request for an overdraft that the bank can either agree or disagree as a matter of discretion and that the charge for returning an item or for having an unauthorised/unplanned overdraft is a charge for that service, which is of benefit to the customer;
- the OFT is seeking to impose judicial price controls on banking services by using the 1999 Regulations and the common law rule on penalties.

The OFT’s position case is that:

- regulation 6(2)(a) and (b) have to be read conjunctively;
- regulation 6(2)(b) only relates to the price/remuneration for the main subject matter of the contract;
- charges for unauthorised overdrafts and returned items are not part of the price payable for the main subject matter of the contract and are subject to an assessment of fairness under the 1999 Regulations;
- the charges are disproportionate to the amount of credit obtained and the period of credit points to unfairness;
- whether charges are capable of being a penalty at common law turns on an analysis of the terms and conditions of the defendant banks and building society and whether there is imposed a contractual obligation not to go overdrawn.

The trial of the action started on 17.1.08 and at the time of writing is continuing.

ARE PENALTIES RECOVERABLE?

13. The general rule is that a penalty clause will not be enforced beyond the sum which represents the actual loss of the innocent party. In that sense the compensatory element is recoverable and the penal element is not recoverable. Whereas contractual clauses that offend public policy such as clauses in unreasonable restraint of trade are blue pencilled out of a contract unless the good can be severed from the bad, a penalty clause is not blue pencilled. The Court has power to direct an enquiry as to damages in a penalty case to avoid the enforcement of the penalty beyond the claimant's actual loss.
14. In ***Jobson v Johnson [1989] 1 WLR 1026***, the penalty clause provided that if the purchaser of shares by instalments defaulted in the instalments he would transfer the shares back to the vendors at a fixed price. The clause was held to be a penalty clause. It was further held that, if the shares had been worth the same as or less than the innocent party's loss, an order for specific performance could have been made. In so far as the value of the shares exceeded that loss, the proper remedy was to sell the shares and pay the value of the innocent party's loss to the innocent party out of the proceeds of sale with the surplus being paid to the contract breaker.

EVIDENCE REQUIREMENTS

15. The onus is on the party challenging the contractual clause to establish that it is a penalty, not on the party seeking to enforce it. As there is a predisposition to uphold liquidated damages clauses, particularly in commercial contracts, the initial evidential burden is on the party challenging the clause to adduce some clear evidence to enable the Court to find that the clause is a penalty. However, there are limits to the evidence that can be adduced as the test is primarily objective. A genuine pre-estimate does not mean a genuine or honest or accurate calculation. A pre-estimate is genuine if it is reasonable in all the circumstances of the case as at the date of the contract. The court looks at the matter in the round, not by nice calculation. The pre-estimate does not have to be right to be reasonable.
16. Evidence to support a liquidated damages clause may include evidence of the thought processes and calculations that went into the agreement of a liquidated damages clause. These do not need to be precise and, indeed, are never likely to be so. Subsequent events after the contract has been made may provide valuable evidence as to what could reasonably be expected to be the loss at the time the contract was made.
17. The terms of the clause itself may give rise to a rebuttable inference that it is not a genuine pre-estimate of damage, but a penalty. But the party relying on the liquidated damages clause may be able to show by evidence that owing to special circumstances, a breach in those special circumstances which would

be liable to cause him a greater loss of which the stipulated sum is a genuine pre-estimate.

18. There must be a substantial discrepancy between the level of damages stipulated in the contract and the level of damages likely to be suffered before it can be said that the agreed pre-estimate is unreasonable. The parties are allowed a generous margin. A penalty arises if the sum paid on breach is extravagant or unconscionable. This is a broad and simple question, not calling for detailed analysis of the contractual background.
19. The clause has to be assessed against relevant commercial considerations and market expectations. For example, in **Lorsdale Finance plc v Bank of Zambia [1996] QB 752**, Colman J said at pp 766/767, as most syndicated loans included default interest and were set up in London or New York, the English courts should adopt an approach to default interest on syndicated loans that was consistent with the approach adopted by the courts of New York.
20. When suing on a liquidated damages clause, consideration should be given to adducing evidence so that common law damages can be calculated. On the one hand, this produces a fall back position in the event that the clause is held to be a penalty and unenforceable beyond the normal common law damages. On the other hand, it may highlight the disparity between common law and liquidated damages.

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