Law Society of Scotland

Consultation Response

Scottish Law Commission: Discussion Paper on Penalty Clauses

2 March 2017

Introduction

The Law Society of Scotland is the professional body for over 11,000 Scottish solicitors. With our overarching objective of leading legal excellence, we strive to excel and to be a world-class professional body, understanding and serving the needs of our members and the public. We set and uphold standards to ensure the provision of excellent legal services and ensure the public can have confidence in Scotland's solicitor profession.

We have a statutory duty to work in the public interest, a duty which we are strongly committed to achieving through our work to promote a strong, varied and effective solicitor profession working in the interests of the public and protecting and promoting the rule of law. We seek to influence the creation of a fairer and more just society through our active engagement with the Scottish and United Kingdom Governments, Parliaments, wider stakeholders and our membership.

The Society's Obligations Law Sub-committee welcomes the opportunity to consider and respond to the Scottish Law Commission's Discussion Paper on Penalty Clauses. The Sub-committee has the following comments to put forward for consideration.

List of Questions

Question 1:

Do consultees know of information or statistical data or have comments on any actual or potential economic impacts of either the current law relating to penalty clauses or any proposed reform of that law? We would especially value information about why and how penalty clauses are used, the effects of their deployment, and their impact on small and medium-sized enterprises.

- We have no information or statistical data regarding the economic impact of penalty clauses.

Question 2:

Should the decision in Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis be left to 'bed in', with the further development of the law and its application being kept under review, but no specific law reform being recommended at this point?

- Our preference would be to leave matters to bed in. The impact of the *Cavendish* and *ParkingEye* cases is already being felt in that commercial advice has been given on the appropriate framing of contracts. In light of those decisions, it is now fairly regular for commercial contracts to set out the commercial/social justification for any clause which may be impugned as a penalty e.g. to ensure prompt payment for goods/services. It is also now common to frame the clause as a conditional primary obligation rather than a purely secondary obligation, for example, payment on specified

event. Such careful drafting can avoid engaging the penalty rule at all if the provision is drafted on that basis.

We note your comments in Paragraph 4.6 where the commentator considered decisions declining to enforce penalty clauses would disappear. We fear such a view is premature. One may look, for example, at the decision of the English case of *First Personnel Services Limited* v *Halfords Limited* (2016) EWHC 3220 (CH). The dispute concerned the fees payable in relation to temporary workers supplied to the Defender by a recruitment company. The contract contained the following clause:-

Clause 4(i) "Charges which represent wages paid are invoiced weekly and are payable within seven days of the date of FPS's invoice. Any invoice outstanding over seven days from the date of payment shall carry interest on the balance at the rate of 2% per month or part thereof until payment".

The rate of interest provided in the clause was in excess of the rate of interest generally awarded in respect of commercial debts at that time. The recruitment company argued that the rate was not out of all proportion to the legitimate interest in enforcing punctual payment of the invoice and having regard to their own liability to pay employees. The Court, however, held that the interest provision was penal and unenforceable on the basis that the rate was so far above the normal commercial level, prescribed under Section 6 of the Commercial Debts Act 1998 (i.e. 8% above the official bank rate). Accordingly, it failed to support the legitimate interest identified.

Whilst we acknowledge that perhaps this is an area which could benefit from reform, it appears to us that commercial parties have already taken steps to adjust their commercial contracts in light of the decision. Further we consider that a period of stability would be useful to allow the Supreme Court decision to take effect. Certainly in light of the *First Personnel* case above it seems that some of the initial reactions by commentators are inaccurate.

We would be hesitant to create a difference of approach between Scotland, and England and Wales at this point.

Question 3:

Should the common law on penalties be abolished (i) outright; or (ii) in its application to contracts between parties all acting in the course of business; or (iii) in its application to consumer contracts?

- The common law on penalty clauses should not be abolished in its entirety. The principal reasons for that is public policy grounds (similar to those identified by Lord Hodge in *ParkingEye*) where it must be the case that it is a legitimate power of the Court to regulate and refuse to implement unconscionable bargains. The second reason is that identified at Paragraphs 4.21/22 and the impact upon third parties ie those not parties to the contract.

Question 4:

Should it be provided that the common law rule against penalties is abolished, to be replaced by a regime directed at regulating specified types of contract terms if they have excessively penal effects?

- If the common law rule against penalties was to be abolished then we would agree that it should be replaced by a regime directed at regulating specified types of contract terms if they have excessively penal effects.

Question 5:

Should a term of a contract be regarded as potentially subject to regulation for penalty only if it becomes operational upon a breach of contract by the party to whom the penalty would be applied?

- Yes. Hitherto, regulation of penalties has been restricted to those triggered by breach rather than other events. Whilst this leaves parties to argue (and Courts to decide) whether a particular effect is triggered by a breach or event and gives parties an opportunity to contract round the penalty rule, we would be very concerned to extend this regulation more broadly. In particular, there is a risk that terms which reflect a decision about pricing or another *quid pro quo* would end up being assessed for reasonableness. It would not seem to us to be appropriate, for example, for a business customer based in Glasgow to have a potentially different interpretation placed on his interest rate contract with his bank from a business customer based in Manchester or Bristol. This would potentially lead to further uncertainty in an area where there is no significant problem or issue to our knowledge.

Question 6:

Or should the scope of the concept be extended to cover also terms

(a) providing for early termination of the contract and/or

(b) giving a party options between different ways of performing its obligations under the contract but the choice of one has relatively adverse consequences for the party compared to the other?

- See answer to Question 5 above.

Question 7:

In the light of the proposed express provision making contractual penalties generally enforceable, do consultees agree that judicial control over contractual penalties that are excessively penal in their effects

should be possible whatever form the penalty takes (e.g. a payment, a forfeiture, a transfer of property, a withholding of performance otherwise due)? Please explain any disagreement, including that relating to any particular kind of clause.

- We would agree that the judicial control should apply whatever form the penalty takes. It appears to us to be entirely logical and consistent for such an approach to take and indeed if it were to apply to say payment but not say transfer of title to property then that would appear to be entirely inconsistent and illogical.

Question 8:

Is it un-necessary to empower the court to consider substance rather than form when deciding whether a clause is within the scope of the new rule against 'excessive penalty'?

- Yes, we agree with your comments in relation to this point and, inter alia, in relation to retention.

Question 9:

Do consultees also agree that there should be provision exempting from judicial control penalties which are specifically provided for in other enactments or rules of law?

- Yes.

Question 10:

Do consultees agree that conventional irritancy clauses should be excluded from the controls against 'excessive penalty'?

- Yes.

Question 11:

Should it cease to be possible for a court to declare a clause unenforceable for excessive penalty (apart from consumer cases)?

- If the view is taken that this area of law should be reformed then it appears to us that it should be appropriate for the Court to declare a clause as an excessive penalty - and therefore subject to judicial modification - on the basis that it should not exceed the real and necessary actual expenses/losses incurred.

Question 12:

Should the only sanction for the excessive penalty of a clause (apart from consumer cases) be judicial modification?

- See answer to Question 11 above.

Question 13:

Would a useful guideline in determining excessive penalty be a comparison between the stipulated penalty and the actual harm or hurt to the creditor's legitimate interests, considered in the light of what the parties could reasonably assess on these matters at the time of contracting and all other relevant circumstances?

- We think what is suggested is a reasonable basis. This would take into account the issues identified on the long term PPP type schemes.

Question 14:

Should this guideline seek to spell out in a non-exhaustive way what may be a legitimate interest of the creditor in the penalty clause? This could include –

(a) actual performance of its obligations by the debtor,

(b) encouragement of prompt or early performance by the debtor,

(c) avoidance of litigation, and

(d) other commercial interests of the creditor.

- On balance we think that it would not be of much assistance to specify the legitimate interests which may be set out. We think that there would be sufficient scope for a party in the event that any contract did proceed to litigation to set out at that time what legitimate interest they were seeking to protect as there could be a wide variety of issues. Whilst we appreciate the suggestion is that the list is "non-exhaustive" we would question whether or not the list would, in itself, be particularly useful.

Question 15:

Views are invited on what more, if any, legitimate interests might be mentioned in such a list, such as –

(1) *the protection of third parties who will suffer loss through breach or other performance-related event but who are not party to the contract and have no other means of recovering their losses;*

(2) *the promotion of wider societal goals favoured by the creditor in the obligation.*

- We think that the potential list of legitimate interests which could be protected is very large. Whether an interest could be considered legitimate or not would depend on the subject nature of the contract and the parties to that contract; we therefore would not favour adding to the list.

Question 16:

Should contracting parties be encouraged to state in their contracts the interests which they seek to protect by their penalty clauses? Are there any interests apart from the punishment of the penalty-debtor which should be expressly excluded as illegitimate?

- For the reasons set out above, we do not consider that the contracting parties should be encouraged to state the interests which they seek to protect. We do not wish to suggest any other interests which should be expressly excluded.

Question 17:

Would further useful guidelines be –

(a) *whether the penalty clause had been negotiated between the parties at arms' length;*

(b) *the availability of independent legal advice to the debtor under the penalty clause at the time of contracting;*

(c) *where the penalty clause was un-negotiated, the steps taken by the creditor to bring the penalty clause to the debtor's attention at the time of contracting, or the extent to which the debtor was aware of the existence and effect of the clause;*

(d) *to take account of the actual or anticipated resources of the debtor as known to or reasonably anticipated by the creditor at the time of contracting?*

- It seems reasonable that when parties have negotiated a contract at arms' length there should be a presumption against judicial intervention. If it is clear that independent legal advice has been obtained then again we think this would be a reasonable presumption against interference.

  However, the reverse is not necessarily the case :the absence of independent legal advice would not in our view necessarily mean that any presumption should be made. We consider absence of

independent legal advice should be neutral unless there was a particular reason why the availability or presence of independent legal advice would be relevant. See for example cautionary obligations and the cases following *Bank of Scotland* v *Smith* 1997 SC (HL)111.

(C) We have some sympathy with the views expressed by Professor Fisher or the confusion as to whether or not the clause has been incorporated as opposed to whether or not it is reasonable. We think however that for incorporation the usual rules should apply ie that steps must have been taken by the creditor to bring the clause to the attention of the debtor.

(D) We consider that consideration of the actual or anticipated resources of either or both parties could be useful in certain, mor extreme, circumstances, for example where payment under the clause in question would be likely to render the debtor insolvent.

Question 18:

Would another useful guideline be that in determining excessive penalty a court should have regard to custom and practice in the relevant market?

- Yes we consider that the custom and practice in the relevant market would be of great assistance. It is, in our view, against the relevant market where the question of excessive penalty can be best judged. What may be deemed excessive in, for example, a "prime" credit loan by a High Street Bank may not be excessive in a tertiary bridging finance loan.

  We note that this may not be a helpful guideline in new markets, where custom and practice has not yet been established. We consider that it is important for legislation to allow for market developments and customs and practice should be allowed to develop as markets evolve.

Question 19:

Might there be a guideline that in cases where the penalty clause becomes operational on a breach of contract a court could have regard to whether or not the breach was trivial?

- We would favour the suggestion that if there was a trivial or trifling breach then it should not attract any penalty.

Question 20:

Views are invited on the most useful word or phrase (if any) with which to characterise the excessive penalty that is to be subject to judicial control (e.g. 'manifestly' or 'grossly excessive', 'out of all proportion', 'extravagant', 'exorbitant', 'unconscionable'), bearing in mind (1) that the exercise of judicial control is to be

exceptional and not a matter of nice calculation in any particular case; and (2) the possible guidelines on what will constitute excessive penalty set out in questions 13-19 above.

- We do not have particularly strong views on the wording to be used however on balance we would favour "excessive or perhaps grossly excessive penalty". It seems to us that this would take into account the issues identified in the PPP/PFI type cases where an assessment has to be made at the outset as to what is reasonable and whether or not some years down the line it remains proportionate. That said, we have no particular difficulty in the other phraseology suggested.

Question 21:

Should the court be empowered to grant any order that seems just in all the circumstances when it modifies an excessively penal clause (or holds it unenforceable if that sanction is retained)?

- Yes, it seems to us to be appropriate that the court grant any order which they think is appropriate and should have a wide discretionary power in that regard. We would compare that to the powers available to the court in the Companies Act 2006 for the remedies available under unfair prejudice.

Question 22:

Should the court be encouraged to use the list of factors to be taken into account in determining excessive penality in making any order modifying the penalty in question?

- We would favour a wider discretionary power on the judge.

Question 23:

Should it be more specifically provided that any order for modification of the excessive penalty should do no more than remove its excessive element?

- It seems to us that the discretionary powers suggested above should be to modify the excessive element of the penalty rather than the penalty *in toto* and therefore we support the suggestion made.

Question 24:

If the answer to the preceding question is affirmative, do consultees agree that the words from "in all cases" to "making the debt effectual" in section 5 of the Debts Securities (Scotland) Act 1856 should be repealed?

- Yes. If the foregoing is implemented then it would appear that the wording in the Debts Securities (Scotland) Act 1856 would, in effect, be redundant. We would be keen to avoid the confusion which might arise if two different remedies were potentially available.

Question 25:

Should the legislation provide specifically that clauses which provide for liquidated damages, i.e. are based on a genuine pre-estimate of the loss likely to be caused by a breach of contract, cannot be held to be penal, no matter what the later circumstances may be?

- We agree with the view that any additional statement here is unnecessary but can see no harm in what is being suggested.

Question 26:

Do consultees agree that only a party should be able to raise the issue of excessive penality?

- We consider that the parties to the contract and any third party with a right arising from the contract whose exercise or satisfaction would be affected by the penalty should be entitled to seek modification of the relevant penalty clause.

Question 27:

Should the court be required to modify a penalty found to be excessive, or should the remedy be at the discretion of the court?

- As indicated above we favour the court having a reasonably wide discretion and therefore would not suggest that the court be required to modify a penalty but leave the remedy to the discretion of the court. There may be cases where the requirement to modify the excess penalty would in itself lead to unjust results.

Question 28:

Do consultees agree that the initial onus of showing that a penalty is excessive should lie on the party so contending?

- Yes it would appear to us fairly obvious that the onus should lie on the party challenging the penalty as excessive. Where a party has entered into a bargain and they are the ones seeking to vary it the onus should be on them to demonstrate why it should not be enforced as originally agreed.

Question 29:

Do consultees agree that it is not necessary to have legislative provision on the cumulation of a penalty and other remedies?

- We agree.

Question 30:

Do consultees agree that in any law on penalty clauses it should be made clear that parties cannot contract out of the application of that law?

- Yes, it would appear to be entirely illogical to be able to contract out of these provisions.

Question 31:

Do consultees agree that the proposed rules on penalties should apply to such penalties provided for in bonds and other unilateral voluntary obligations in the same way as to those provided for in contracts?

- We agree. There is no logical reason to exclude unilateral voluntary obligations or bonds.

Question 32:

Do consultees agree that any new legislation (including outright abolition of the penalties rule, in whole or in part) should apply only to penalty clauses agreed after it comes into force?

- Yes. We are generally against retrospective legislation and take the view that parties should be clear on what law will apply at the time they enter into their obligations. Any new legislation should only apply to clauses agreed after they come into force.

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