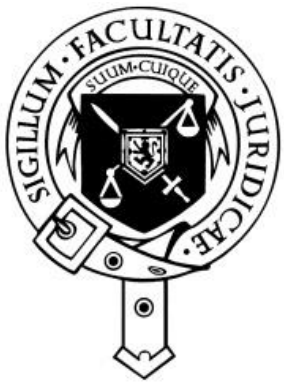
Faculty of Advocates



Response

to

Scottish Law Commission,

Discussion Paper on Penalty Clauses

(Discussion Paper No. 162)

Faculty Response to Scottish Law Commission Review of Contract Law

The answers to the following questions are principally based on the assumption (referred to at 4.25 of the Discussion Paper) that reform is required and that notwithstanding the Faculty's answer to question 2 below.

Q1. 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. (Paragraph 1.16)

1. The Faculty does not know of any information or statistical data about the actual or potential economic impacts of either the current law relating to penalty clauses or any proposed reform of the law in this area. The Faculty regrets that it is not able to input further into this question.

Q2. 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? (Paragraph 4.16)

2. Having considered the Scottish Law Commission Discussion Paper the Faculty is of the view that the Supreme Court decision in the cases **Cavendish Square Holdings BV v Makdessi, Parking Eye Ltd v Beavis (Consumers' Association intervening) 2016 AC 1172** should be allowed to "bed in" with the further development of the law being kept under review, but no specific law reform being recommended at this point.

3. As the Discussion Paper notes, Lord Hodge's judgment addressed Scots Law directly. Lord Hodge set out what he described as the correct test for a penalty, namely

> "whether the sum or remedy stipulated as a consequence of the breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."

4. Lord Hodge thereafter explained in paragraphs 262 – 266 why he was persuaded that the rule against penalties should remain part of the law of Scotland. He cited three reasons. In his second reason, he referred specifically to the fact that the Scottish Law Commission itself had in 1999 recommended the retention of judicial control over

penalties. In effect, Lord Hodge's test, set out above, provides for such retention of judicial control over penalties. Accordingly, the Faculty's view is that specific law reform is not recommended at this time but rather that developments in the law, post **Cavendish** supra, ought to be kept under active review for a reasonable period of time.

Q3. 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? (Paragraph 4.24)

5. Standing the Faculty's position in relation to question 2 above, the Faculty does not advocate, at present, the abolition of the common law on penalties either (i) outright, (ii) in its application to contracts between parties all acting in the course of business, or (iii) in its application to consumer contracts.

6. In relation to (ii), parties all acting in the course of business can cover a multitude of entities, not all of whom will have equal bargaining power or access to expert legal advice. Lord Hodge's test may accordingly present as a sufficient final safeguard.

7. The case for abolition is perhaps easier to make in relation to (iii) consumer contracts for this is an area of law in which Parliament has intervened and most recently by way of the **Consumer Rights Act 2015** which came into force on 1 October 2016. However this is also an area of law where arguably the final safeguard of judicial control is required.

8. Parliament has intervened in consumer matters for it is recognized that this is an area where parties are unlikely to have equal bargaining power or access to legal advice. The Faculty is of the view that any question of abolition of the common law of penalties in its application to consumer contracts is at present premature. The **Consumer Rights Act 2015** requires to be kept under review for a sufficient period of time before any such reform should be considered.

Q4. 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? (Paragraph 4.36)

9. Standing the Faculty's position in relation to Question 2, the Faculty does not consider that the common law rule should be abolished at this time. However, if it were, the most careful and robust consideration would require to be given to any draft legislation, for the legislature would be interfering with a valid and enforceable contract and limiting the ability of parties to enter into bargains on terms they see fit. As question 7 makes clear, any legislation would have to be drafted on the basis that the contract, and its terms, were generally enforceable.

Q5. Should a term of a contract be regarded as potentially subject to regulation for penality only if it becomes operational upon a breach of contract by the party to whom the penalty would be applied? (Paragraph 5.11)

Q6. 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? (Paragraph 5.11)

10. The Faculty is of the view that Questions 5 & 6 fall to be considered together. The "Bad Leaver" example set out in the Discussion paper at paragraph 5.8 – 5.10 is a good example of why a term of a contract should not be subject to regulation only if it becomes operational upon a breach of contract by a party to whom the penalty would be applied. The "Bad Leaver" example is an example of a situation that may benefit from legislation independent of a consideration of penalty clauses.

11. In general however, the Faculty accepts that the rule against penalties applies in the context of a breach of contract and in general the Faculty is of the view that should remain the case.

Q7. 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. (Paragraph 5.20)

12. With the exception of withholding of performance otherwise due, other than payments on breach, this question was effectively anticipated and discussed by Lord Hodge at paragraphs 225 – 238 of his judgment. The Faculty respectfully agrees with all he writes in these paragraphs.

13. It is suggested, however, that the controls should not be extended to the remedy of withholding performance. As the Discussion Paper notes, this is an important and widely used remedy in Scots law. It is a reflection of mutuality in contract, a fundamental principle which lies at the heart of Scots contract law. Great care should therefore be taken before extending controls on penalty clauses to the remedy. Arguably, it is already subject to sufficiently robust controls, and treatment as a penalty is therefore unnecessary. Again, as noted in the Discussion Paper, a Scottish court, as part of the exercise of its equitable powers, may refuse access to the remedy where a party is seeking to make use of it in an abusive manner (as explored by Lord Drummond Young in **McNeill v Aberdeen City Council (No 2) 2014 SC 335**). Such equitable controls have been shaped in many judgments over a long period of time and are arguably more appropriate to deal with abusive behaviour in that particular context. Extending controls applicable to penalty clauses to withholding performance is therefore not only unnecessary, but could introduce confusion into this important area.

Q8. 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 penality'? (Paragraph 5.20)

14. No, it is the Faculty's view that it may be necessary for the court to consider substance when deciding whether a clause is within the scope of the new rule against excessive penality. Indeed it seems unlikely that a Scottish court would require to be encouraged to consider substance rather than form in its approach to penalty clauses. As made clear in **Cavendish** supra,

> "The classification of terms for the purpose of the penalty rule depends on the substance of the term and not on its form or on the label which the parties have chosen to attach to it."

And as Lord Hodge put it,

> "…the court's focus on the substance of the contractual term would enable it in an appropriate case to identify disguised penalties."

The Faculty agrees with such views.

Q9. 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? (Paragraph 5.20)

15. Yes, the Faculty agrees that controls over penalty clauses should not apply where the penalty is already specifically provided for in other enactments.

Q10. Do consultees agree that conventional irritancy clauses should be excluded from the controls against 'excessive penality'? (Paragraph 5.24)

16. Yes, the Faculty agrees that irritancy clauses should be excluded from any controls in this context. The exercise of a right to irritate a lease is already subject to separate statutory controls in terms of the **Law Reform (Miscellaneous Provisions) (Scotland) Act 1985.**

Q11. Should it cease to be possible for a court to declare a clause unenforceable for excessive penality (apart from consumer cases)? (Paragraph 5.32)

17. The Faculty agrees that it should cease to be possible for a court to declare a clause unenforceable for excessive penality (except for consumer cases). If, as envisaged, the general rule will no longer be the treatment of penalties as illegal or contrary to public policy, then the outcome or legal analysis that the clause is unenforceable will no longer be appropriate. More generally, there are other pressing reasons to avoid "unenforceability". The meaning of unenforceability, and the need for a class of obligations which is unenforceable, have been unclear. This was highlighted by Professor McBryde in his treatment of illegal contracts, specifically gambling and smuggling contracts, in *The Law of Contract in Scotland.* It has, for example, not been

clear what difference it makes to describe a term in a contract or a whole contract as "unenforceable" rather than "void" (it may not be the case, for example, that title to property can pass under one but not the other). It is questionable whether the status of "unenforceable" is even required. "Unenforceability" tends not to be familiar to those from other European jurisdictions. In short, there are fundamental uncertainties in the meaning and effect of "unenforceability" in Scots law. It is therefore a positive step to move away from this term in the context of penalties.

18. Different considerations apply in the consumer context. Significantly, "unenforceability" is the effect applied by the Unfair Terms in Consumer Contracts Directive, now embodied in the UK in the **Consumer Rights Act 2015**. Thus, to choose unenforceability for penalties in the consumer context is consistent with the overall structure for the protection of consumers, which applies because of that Directive. Taking a stricter approach to consumers as opposed to commercial cases is justifiable given the inequality of bargaining power, which virtually always exists in the former but not necessarily in the latter.

Q12. Should the only sanction for the excessive penality of a clause (apart from consumer cases) be judicial modification? (Paragraph 5.32)

19. Generally, the Faculty supports the introduction of a power of judicial modification, although it is suggested that such a power ought to be considered exceptional and used sparingly. This would be consistent with the overall attitude of the Discussion Paper which is to uphold liquidated damages provisions freely entered into by parties with legal advice and of broadly equal bargaining power. In other words, any erosion of contractual freedom outside consumer cases should be kept to a minimum.

20. As is continually illustrated in our reported cases, many commercial contracts routinely drafted by Scottish practitioners are extremely complicated documents, the product of perhaps months of negotiation between the opposing solicitors. Provisions which are arguably penalties may be "hidden" by clever drafting, discussed above in paragraph 14. Taking account of these factors, it is suggested that it may be an extremely difficult exercise for a judge to modify such a clause. Although judges gain an enormous amount of knowledge through their analysis of contracts whilst deciding cases, they are not drafting clauses on a day-to-day basis. Many might disagree with views recently expressed by Lord Drummond Young in **Hoe International v Andersen and Anor 2017 CSIH 9** that the commercial background to a contract dispute may be considered to be within judicial knowledge. It is important to recognise in the context of penalty clauses that judicial modification may be an extremely difficult exercise. Is it envisaged, for example, that the parties to the dispute could lead evidence on the aim and meaning of the supposed penalty? Such evidence could assist the judge in making an appropriate amendment. It should also be borne in mind that an amendment to one clause which is arguably a penalty may have unexpected implications for other clauses in the same contract.

21. The Faculty agrees that reducing the penalty to the amount which would have been recovered had the party sued for damages on its own is not an acceptable outcome. The Faculty suggests that a power of judicial modification is the better solution. New legislation should emphasise that the power should be used sparingly in exceptional circumstances where it is clear that one of the parties intended the provision to operate

in an abusive manner. Similar powers are used sparingly and relatively rarely in, for example, French and German law.

22. The judiciary may find the exercise of such powers, unusual before now in the UK, difficult. It will be recalled that another provision envisaging judicial amendment, the **Consumer Credit Act 1974, s 137(1)**, which introduced a judicial power to amend extortionate credit bargains, was used extremely rarely and was eventually repealed. It may be that judicial training will be required to encourage and properly equip the judiciary to wield such new powers.

Q13. Would a useful guideline in determining excessive penality 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? (Paragraph 5.53)

23. Yes, the Faculty agrees that a comparison between the stipulated penalty and the actual harm or hurt to the creditor's legitimate interests would be a useful guideline in determining an excessive penalty, considered in the light of what the parties could reasonably assess on these matters at the time of contracting and all other relevant circumstances. It should be borne in mind that "loss" here is considered expansively and extends beyond what could normally be recovered as part of a damages award. This can undoubtedly act as a pointer towards what might be a "legitimate interest" protectable by way of a penalty clause.

Q14. 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. (Paragraph 5.53)

24. Yes, given the criticisms levelled at the 2010 Scottish Government consultation, i.e. that more guidance on what might constitute a "legitimate interest" was required, the Faculty is of the view that the guidelines should provide a non-exhaustive list of possible legitimate interests.

Q15. Views are invited on what more, if any, legitimate interests might be mentioned in such a list, such as:
(a) 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;
(b) the promotion of wider societal goals favoured by the creditor in the obligation. (Paragraph 5.53)

25. The Faculty does not suggest further possible legitimate interests. Legitimate interests may be specific to a commercial context, and it seems misconceived to seek to identify highly particular commercial ideas. It is suggested that the non-exhaustive list should

be kept broad and general in order to give parties a flavour of the types of interests which are "legitimate".

26. The Faculty agrees that, in accordance with 15(a), losses suffered by third parties could be identified as legitimate interests. As 15(a) envisages, parties should be encouraged to include appropriate drafting in the clause explaining why such third parties are unable to recover such losses themselves, and why the contracting party is forced to recover such third party losses through use of a penalty clause.

27. Given that the Supreme Court in **Parking Eye** gave such a strong indication that wider societal ideas could be legitimate interests in liquidated damages clauses it is suggested that this category should indeed be included in guidelines, as envisaged in 15(b). It seems likely that certain contracting parties will want to use penalty clauses for reasons of, for example, environmental protection.

Q16. 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? (Paragraph 5.53)

28. The Faculty considers that parties ought to be encouraged to state the legitimate interests they are seeking to protect in their penalty clauses. This will play a useful role by ensuring that the contracting parties are absolutely clear on the reason why the clause is being used. It will also encourage reflection on whether the relevant interests are indeed legitimate. It may, of course, lengthen the time taken to negotiate a contract, but it may ultimately save time when a dispute arises. It seems likely that commercial parties will already be inserting such drafting into their contracts in the aftermath of the **Cavendish** and **Parking Eye** litigation in order to be absolutely sure that their liquidated damages provisions will be enforceable.

29. In determining whether any interests apart from those aiming to punish the penalty-debtor should be excluded as illegitimate, guidance could be taken from the current law on illegal contracts and contracts which are contrary to public policy. The courts in the UK have a well-developed way of approaching such contracts and looking at developing norms within society in order to decide questions of enforceability. Essentially, the exercise of deciding whether or not a contract or contractual clause is unenforceable because it is illegal or contrary to public policy may have much in common with the exercise of deciding whether an interest protected by a penalty clause is legitimate or not.

Q17. 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? (Paragraph 5.58)

30. The Faculty considers that the considerations set out at (a) to (d) above may be useful guidelines in determining excessive penality. They may not be relevant in all cases but, as general guiding factors, would appear to be sound.

Q18. Would another useful guideline be that in determining excessive penality a court should have regard to custom and practice in the relevant market? (Paragraph 5.60)

31. The Faculty considers that this may be another useful guideline in some cases, although it should not, on its own, be conclusive as to the question of whether there is excessive penality.

Q19. 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? (Paragraph 5.61)

32. The Faculty considers that introducing such a guideline would run the risk of creating more uncertainty for parties regarding the circumstances in which a penalty clause will be enforceable. It would give rise to additional factual circumstances that would require to be investigated before the court could take a view on whether the penalty is enforceable. There will always be 'hard' cases and the Faculty does not consider, on the basis of the current proposals, that there is merit in introducing such a guideline.

Q20. Views are invited on the most useful word or phrase (if any) with which to characterise the excessive penality 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 penality set out in questions 13- 19 above. (Paragraph 5.62)

33. The Faculty considers that the language used by Lord Hodge in the **Cavendish/Parking Eye case** (at paragraph 255) – "exorbitant and unconscionable" – would be appropriate.

Q21. 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)? (Paragraph 5.68)

34. Based on the assumption that the court is to have the power to modify a penalty clause, the Faculty considers that it should be empowered to grant any order that seems just in all the circumstances.

Q22. 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? (Paragraph 5.68)

35. The Faculty considers that the court should not be limited to the list of factors used to determine the excessive penalty, but that it may find those factors useful when taking the whole circumstances into account.

Q23. Should it be more specifically provided that any order for modification of the excessive penalty should do no more than remove its excessive element? (Paragraph 5.68)

36. The Faculty does not consider that the power to modify a penalty clause should be restricted in the way suggested.

Q24. 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? (Paragraph 5.68)

37. The answer to Q23 is not in the affirmative.

Q25. 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? (Paragraph 5.70)

38. The Faculty does not consider that such a provision is necessary or desirable. It would in any event inevitably lead to a dispute over whether the clause in question was, in fact, a genuine pre-estimate of loss and thereby lead to exactly the same underlying test being applied.

Q26. Do consultees agree that only a party should be able to raise the issue of excessive penality? (Paragraph 5.72)

39. Yes.

Q27. Should the court be required to modify a penalty found to be excessive, or should the remedy be at the discretion of the court? (Paragraph 5.72)

40. Since modification is the only remedy, once the court is satisfied that excessive penality is established there should be no discretion as to the remedy.

Q28. Do consultees agree that the initial onus of showing that a penalty is excessive should lie on the party so contending? (Paragraph 5.77)

41. Yes.

Q29. Do consultees agree that it is not necessary to have legislative provision on the cumulation of a penalty and other remedies? (Paragraph 5.82)

42. Yes.

Q30. 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? (Paragraph 5.83)

43. Bearing in mind the public policy dimension in any such legislation, it should be made clear that parties cannot contract out of its application.

Q31. 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? (Paragraph 5.84)

44. Yes.

Q32. 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?

45. Yes.