JONES DAY®

Since the firm's founding in 1893, Jones Day has grown from a small local practice to one of the world's largest international law firms. With more than 2,220 lawyers resident in 30 offices around the world, the firm counts more than half of the Fortune 500 among its clients. Jones Day's success stems from its key strengths: high-value client service, depth of people, experience and resources and a one-firm organisation and culture that allows it to bring the best of the firm to every engagement regardless of the location of the client or the details of their needs. London is an important part of the firm's significant European network, which includes offices in Paris, Frankfurt, Brussels, Madrid, Moscow, Munich and Milan.

In Practice

Authors Marc Isaacs and Nick Davies

The fine line between liquidated damages and penalties

As the Office of Fair Trading ('OFT') challenges unauthorised overdraft charges in the High Court, Marc Isaacs and Nick Davies consider the fine line between liquidated damages and penalties in commercial loan agreements.

LIQUIDATED DAMAGES v PENALTY

Practitioners will be aware that as a matter of English law liquidated damages clauses are generally enforceable while penalty clauses are void. In the OFT litigation, one of the arguments being put forward is that unauthorised overdrafts constitute a breach of contract and the resulting charges constitute penalties which should be rendered unenforceable.

The leading case on penalties is *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, which established that a clause which provides for a genuine pre-estimate of the loss that a lender would suffer as a result of breach of contract by the borrower will constitute a liquidated damages clause and accordingly be enforceable. On the other hand, a clause which provides for an amount to be paid that is intended to act as a deterrent against the borrower from breaching the contract is likely to constitute a penalty clause and accordingly be rendered unenforceable. The distinction between a genuine pre-estimate of loss and a deterrent, however, is not always easy to define.

DEFAULT INTEREST RATES

In the context of loan agreements, the issue of whether a provision constitutes a penalty or not is most often examined in the context of a default interest provision. If drafted carefully, a default interest provision should not constitute a penalty. It should be noted that default interest provisions are governed by both statute and common law. The statutory regime is found in the Late Payment of Commercial Debts (Interest) Act 1998 and the Late Payment of Commercial Debts Regulations 2002 (SI 2002/1674), which enable default interest to be charged at the statutory rate, currently 8 per cent above the Bank of England's base rate. This is likely to be higher than contractual rates, but practitioners should be aware that the statutory rate may not always be awarded in full if the courts determine that the interests of justice so require. One of the factors that will be considered when making that determination will be the lender's conduct. Consequently, practitioners should continue to include a default interest provision in loan agreements, but the rate of default interest should be chosen carefully so as to avoid constituting a penalty. The market has generally settled on a default interest rate of 1 to 2 per cent above the ordinary contractual rate. Once you move above that range, it becomes harder to justify the rate as being a genuine pre-estimate of loss.

The following case law provides some (albeit limited) guidance on the question of at what point a default interest rate becomes penal. In *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752, a default interest rate of 1 per cent above the ordinary contractual rate was held to be enforceable. In this case, Colman J moved away from the test established in the *Dunlop* case and considered: (a) if there was a commercially justifiable reason for the provision; and (b) whether the dominant purpose of the provision was to compensate the lender for default or to deter the borrower from committing that default. The amount that should be payable on default should be comparable with the loss that such default might cause. Colman J stated that 'modest' default interest rates, which remained undefined, would be enforceable, adding that provisions which attempt to have retrospective effect or make default interest payable for an arbitrary future period would constitute penalties. As such, practitioners should ensure that default interest periods coincide with the period when non-payment is continuing.

At the other end of the spectrum, in *Jeancharm Ltd (t/a Beaver International) v Barnet Football Club Ltd* [2003] All ER (D) 69 (Jan), a default interest rate of 5 per cent per week, which equates to 260 per cent per annum, was held to be a penalty.

BREACH OF CONTRACT

As established in the *Dunlop* case, in order for a default interest provision to constitute a penalty, it has to be established that the provision is intended to act as a deterrent against the borrower from breaching the contract. Typically a default interest provision provides for an increased margin to apply following non-payment of an amount due under the loan agreement. Clearly non-payment of an amount due will constitute a breach of the loan agreement and the issues described above will need to be considered in determining whether the provision constitutes a penalty.

Sometimes, however, default interest provisions are drafted so as to apply upon the occurrence of an event of default. If the event of default that has occurred is unrelated to a breach of contract (such as the occurrence of a material adverse change), then the default interest provision could be held to be enforceable irrespective of the applicable rate of interest.

CONCLUSION

In situations where a genuine pre-estimate of loss is difficult to quantify, practitioners should adopt a 'best guess' policy, remembering to keep a record of any calculations. So long as the chosen figure does not exceed the greatest loss which could be suffered, the clause is likely to be enforceable. ■

Biog box

Marc Isaacs is a partner in the Banking & Finance Team in Jones Day's London office and has extensive experience in advising on a wide range of finance transactions acting for senior and mezzanine finance providers as well as borrowers on both UK domestic and cross-border international financings.
Email: misaacs@jonesday.com
Nick Davies is an associate in the Banking & Finance Team in Jones Day's London office. Email: nickdavies@jonesday.com