Early Termination Charges – Enforceable?

Many ICT customer contracts (e.g. for mobile services and for managed data services) have early termination charges (ETCs). A November 2012 UK case on penalties[1] - applicable in many common law countries - shows how ICT suppliers can improve enforceability, how customers might resist paying ETCs, and how the wrong wording can easily lead to unexpected outcomes. The UK case is one of the rare decisions applicable to ETCs. In another article,[2] we've built on this article, with a case study where the customer saved $1.3M on ETCs by careful footwork.

November 2012

Take a post-paid mobile contract with a handset bundled into the contract. If the customer terminates early, the Telco wants to recoup the unpaid cost of the handset, plus something for the remaining term. But a big plus for the Telco is that the ETC makes the customer stickier: it's harder to churn to another provider. So there is a driver to push up the value of the ETC beyond underlying cost.[3]

Does the liquidated damages (LDs)/penalty legal regime apply if the ETC is higher than cost, so that it is unenforceable?

LDs are commonplace in many ICT and building contracts. For example, if a supplier completes the project late, it must pay LDs of $X per day. That replaces the customer having to go through the difficult exercise of proving the unliquidated damages caused by the delay. But the courts in many common law countries require the LD to be "genuine pre-estimate of damage". Too high and it is an unenforceable penalty.

An ETC regime has overlaps with LDs. The ETC is a fixed figure[4] payable for terminating earlier than the end of the full contract, instead of the supplier having to prove what the actual loss is from losing the customer. If the LD/penalty regime applied, the ETC would have to be a genuine pre-estimate of loss to avoid being unenforceable as a penalty.[5]

If the UK case applies, whether an ETC is covered by the penalty regime hinges – believe it or not – largely on the choice of words. If the ETC is payable due to breach by the customer, the regime applies. If it is payable regardless of breach it's not. And that can come down mainly to choice of words.

Say the contract states:

> You must take the service and pay the monthly fee until the until the end of the contract.

If the contract says the following, it is within the penalty regime:

> If you fail to take the service as contracted, you must pay an ETC of $X.

If it says this, it is not within the regime:

> [Instead of taking the service to the end of the term, you can choose to end the contract early.] If you do end the service, you must pay an ETC of $X.

But the practical effect is largely the same. It comes down to the words.

Why the difference? The first clause involves damages for breach of contract. If the customer fails to pay monthly until the end, it is in breach. The second is a contractual primary right and does not flow from a breach. The customer is given the choice to stop earlier and to pay for stopping early. In the words of a House of Lords case,[6] that second option:

> "...was not a penalty clause because it provided for payment of money upon the happening of a specified event other than a breach of a contractual duty owed by the contemplated payor to the contemplated payee."

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The November 2012 UK case confirms the approach above, but it also illustrates how suppliers can trip up. The clause in *E-Nik* was similar to an ETC clause but instead the clause was called a "take or pay" clause. Those clauses are common in industries such as energy and resources. Under a take or pay clause, the customer must take minimum quantities of product, or pay for those minimum quantities even it doesn't take them.

In the main take or pay case relied on in *E-Nik*,[7] the take or pay clause looked just like the second ETC option: a sum payable on the exercise of a contractual right instead of sum payable for breach. In isolation it wasn't covered by the penalty regime.

But the court linked the take and pay clause to a separate clause stating that the customer must order the minimum quantities. Stitching the two provisions together, the "pay" in the "take or pay" only became payable when the customer was in breach as it hadn't ordered the minimum quantities. So the payment was an LD and subject to the penalty regime.[8] That outcome would have been avoided simply by better words.

That's a lousy basis to distinguish what is in and out of the penalty regime but it is what it is.

Quite a few ICT contracts fall into the ETC trap reflected in the *E-Nik* case. It would happen in our example above if the words in the square brackets in the second option are removed, as that is what happened in *E-Nik*.

Of course there may be other grounds to attack ETCs, some of which are outlined in our article, *Minimise early termination charges on switching ICT suppliers: a case study*.[9] For example, many countries will have credit contract legislation, unfair contract term legislation, and/or regulation designed to enhance the competitive effects of easy churn. That is more likely as to consumers as opposed to business deals.

And quite a few suppliers will mess up their processes, making it hard for them to prove the ETC claim.

1. *E-Nik v Dept for Communities and Local Government* [2012] EWHC 3027. Of course the law in each common law country needs to be checked to see if the UK authority applies.

2. http://www.wigleylaw.com/assets/Uploads/Minimise-Early-Termination-Charges-Case-Study.pdf

3. We use "cost" loosely here to reflect what would be fair for the Telco to recover if the customer leaves early.

4. Or sliding scale of figures.

5. The case dealt with in this article is one of many that confirm that the courts will not be overly narrow in deciding what constitutes a genuine pre-estimate of damage.

6. *ECGD v Universal Oil* [1983] 1 WLR 399 cited in the main authority underpinning *E-Nik*, namely, *M&J Polymers v Imerys* [2008] EWHC 344 (Comm).

7. *M&J Polymers* cited above.

8. Although the supplier won anyway as this was a genuine pre-estimate of damage.

9. http://www.wigleylaw.com/assets/Uploads/Minimise-Early-Termination-Charges-Case-Study.pdf

Wigley+Company
PO Box 10842
Level7/107 Customhouse Quay, Wellington
T +64(4) 472 3023 E info@wigleylaw.com
and in Auckland
T +64(9) 307 5957
www.wigleylaw.com