New LD clause and early termination charge law impact B2B and B2C contract drafters - FAQs

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Speed read

... so many riveting and up-ending recent cases on LD/ETCs, there's a movie in it... or not. With a decision from the UK Supreme Court last week throwing out a century of law underpinning drafting of contracts, and diverging recent Australian law, here are some FAQs on where we are at.

Generally the developments are more pro-customer than pro-supplier but there are possible outliers.

Customers should stop calling liquidated damages (LD) clauses by that name, as the long standing concept of *"genuine pre-estimate of loss"* may be out the window in NZ. It's gone in Australia (so far) and, definitively, in the UK.

There's quite a bit of detail in the new cases, so this is just a highlighter report.

The Detail

What's the difference between early termination charges and liquidated damages clauses?

This is important in getting to the bottom of these issues. In short, LD clauses involve breach: ETCs do not.

ETCs and LD clauses are examples of contract provisions that come in different shapes and sizes (e.g. clauses could involve, say, transfer of assets or extended restraint of trade terms, instead of payment of money). The ETC is a great example of one of two key categories, LD clauses are an example of the other. The distinction is critical.

As the name implies, liquidated damages clauses are all about remedies if there is a breach. Instead of having to prove the $ value of the losses caused by the breach, the figure is fixed (i.e. liquidated). In the language of the judgments, LD clauses apply where a *"primary obligation"* under the contract is breached (e.g. failure to deliver on time), leading to a *"secondary obligation"* (the requirement to pay the LDs). As we'll explain below, there may be room now to have such clauses that capture a money figure that exceeds damages otherwise recoverable if there was no clause in the first place.

ETCs, on the other hand, entail the *"primary obligation"* as the requirement to pay. They kick in without any breach occurring so there is no *"secondary obligation."* For example, *"Your mobile phone contract is for two years but if you want to stop earlier you must pay us an ETC of $100."*

Importantly, as we explain below, obligations can often be set out as either LD clauses or ETCs. For example, that last quote can be restated as: *"Your mobile phone contract is for two years but if you breach by not continuing the contract, you must pay $100."*

What's this about *"genuine pre-estimate of loss"* as to LD clauses?

For around a century, the received wisdom from the leading case on *Dunlop Pneumatic*,[1] relied on time and again including in NZ, has been that if the LD clause figures are not a *"genuine pre-estimate of loss,"* the clause is unenforceable. Broadly, that reflected the idea of what would otherwise be recovered in court as damages, give or take a fairly wide margin, if the LD clause wasn't there. If the LD payment exceeded that amount, it was unenforceable as it is a *"penalty."*

The UK Supreme Court case last week- *Cavendish v Makdessi*,[2] has totally taken away the *"genuine pre-estimate of damages"* concept, on which commercial lawyers drafting contracts have relied for a century. In particular, such clauses can recover for sums well beyond damages. (That's why those relying on LD clauses should call them something else now). The test now is whether the clause *"...imposes a detriment on the contract-breaker so out of proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation".*[3] This could be commercial interests never recoverable in Court. The Supreme Court used descriptors such as *"out-of-proportion detriment"* and *"extravagant, exorbitant and unconscionable."*

Something similar is happening in Australia in the one of the bank charges class action cases, heading to the High Court early next year.[4] There the thinking around how wide the coverage of such clauses can go is even more developed as to the detail. We'll write again about that when the High Court's judgment comes out.

The UK judgment deals with two separate cases. One is the great example - car park charges, which we described *here.* A car park operator charged £85 if a car overstayed beyond 2 hours of free parking at a shopping mall. The mall had an interest in deterring breach of the 2 hour limit primary obligation, in order to free up car parks for other shoppers visiting the mall. The car park operator had an interest in recovering the cost of operating the car park, and making a profit on it. With regard to the context, including general UK car park practice, the charges were neither unconscionable nor extravagant. The car park operators had the legitimate interest noted above. So the clause was upheld.

The odds are that NZ will go down a similar path and move away from the *"genuine pre-estimate of loss"* approach, more so as the Australians are trending down that path too.

What about ETCs?

In the UK, the Supreme Court made clear that the century old rule noted above - from *Dunlop Pneumatic* - should not be extended beyond the primary and secondary obligation scenario. Therefore, in the UK, ETCs are not at risk of being unenforceable as being a penalty. Here, they disagreed with the contrary conclusion of the High Court of Australia in another bank charge class action case, *Andrews v ANZ*, which we describe *here.* It's not yet clear which way ETCs will head.

Conceptually, one of the key aspects of not putting ETCs and other primary obligations into the penalty regime, is that parties to contracts cannot get out of bad bargains by this mechanism (save as to remedies specified in contracts for breach, that is for secondary obligations following breach of primary obligations).

What sort of contracts will the new regimes apply to?

In the UK Supreme Court there were two fact scenarios: one about the car park charges issue and the other about a situation more like ETCs, that is, the obligation to pay was a primary obligation. The parties to the latter contract were sophisticated, well-advised commercial

operators. The car park case involves consumers though, and so there is unequal power, implying that in the UK, the regime applies widely as to LD type clauses. But note that consumer transactions may be covered by statute, such as the unfair contract terms regime in the Fair Trading Act. (In the UK, the car park operator also won on the UK's consumer protection legislation, but more recent UK consumer law may not lead to the same result).

How this plays out in NZ is also not yet clear.

Hang on, I remember there was a case in NZ involving George Kerr's company, Torchlight, in a fight with a rich Australian, involving these issues. Isn't the law up to date here?

No, under the contract in that case,[5] the applicable law was NSW law and so NZ law was not applied.

Can you win with a clause by clever drafting?

Well, yes, there may be opportunity. Take the example above of the two year mobile contract. Drafting this as an ETC (when it could be an LD clause instead) ups the odds of successfully enforcing the clause.

Obviously, stop using the language of liquidated damages, for that implicitly may limit recovery to what would be damages if the clause wasn't there. An example is that this long standing addition to such clauses needs to be ditched, and ideally replaced by a more appropriate explanation: "*The parties acknowledge that the said sum is a genuine pre-estimate of damages.*"

What's next?

The decision of the High Court of Australia, being heard early next year on, among other things, what losses can be included in clauses. We'll write again then.

1. *Dunlop Pneumatic v New Garage* [1915] AC 79
2. [2015] UKSC 67
3. *Cavendish* at [32]
4. On appeal from *Paciocco v ANZ* [2015] FCAFC 50
5. *Torchlight Fund no.1 v Johnstone* [2015] NZHC 2559

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