

REPORT

To: CORPORATE SERVICES COMMITTEE		Subject: CONSULTATION ON THE PENALTY CLAUSES (SCOTLAND) BILL	
From: HEAD OF LEGAL SERVICES			
Date: 22 July 2010	Ref: JM/RT		

1. PURPOSE OF REPORT

- 1.1. The purpose of this report is to seek approval by Committee for the Council's response to the Consultation Paper on the Penalty Clauses (Scotland) Bill.
- 1.2. A copy of the Paper is in the Members' Library and further details are available at:-
www.scotland.gov.uk/Publications/2010/07/penalty-clauses
- 1.3. The closing date for responses to the Paper is 8 September 2010.

2. BACKGROUND

- 2.1. Contracts often contain a penalty clause that can require the party that breaches a contract to pay a monetary sum to the other party to the contract. Disputes can arise about whether or not a monetary sum is due to be paid and, if so, the amount of that sum. It has been recognised that the outcome of such disputes lacks certainty. Furthermore, for certain penalty clauses that can be enforced, the associated monetary sum can be viewed as excessive when contrasted with actual loss that results from the breach of contract.
- 2.2. The Consultation follows a Discussion Paper by the Scottish Law Commission in 1997 and a subsequent Report containing a draft Bill on Penalty Clauses in 1999.
- 2.3. The Consultation also refers to the Principles of European Contract Law and the UNIDROIT (International Institute for the Unification of Private Law) Principles of International Commercial Contracts. Both are documents that contain provision on excessive penalties, thereby enabling penalty clauses to be viewed comparatively.

3. PROPOSALS

- 3.1. The Scottish Law Commission Report in 1999 made certain recommendations. These included provision for determining that a penalty is 'manifestly excessive' with such a determination taking into account relevant circumstances. Also recommended was that penalties should apply regardless of the form that the penalty takes, with irritancy clauses in leases being excluded due to the possibility that, at some future date, legal provision for leases may be subject to review. Further recommendations included the provision to modify a penalty to the extent that it would be enforceable and that proposed legislation should not be retrospective.
- 3.2. The Scottish Law Commission recommendations were included in a draft Bill as part of the 1999 Report. That draft Bill has been updated to take account of the Scottish Parliament. The substance of the draft Bill that now forms part of the Consultation does not differ significantly from the draft Bill in 1999.
- 3.3. As part of the consideration of the draft Bill, the Consultation requested answers to five questions. Those consulted as a whole are listed in the Consultation, whereby responses will be collated in order to inform any amendments to the draft Bill before it is introduced to the Scottish Parliament. The Council's response is detailed in Appendix 1 to this report.

4. SUMMARY OF THE COUNCIL'S RESPONSE TO THE CONSULTATION PAPER

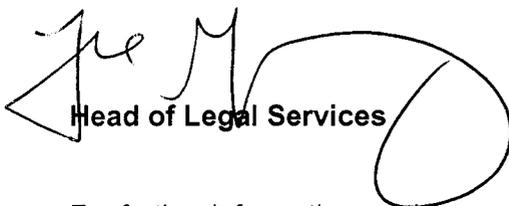
- 4.1. As the Council can include penalty clauses within its own contracts whilst also entering into contracts that include penalty clauses, consideration has been given to whether or not the draft Bill strikes the appropriate balance in protecting the Council's interest from both perspectives. The draft Bill has been considered not just in isolation but in conjunction with comparative international legal material and has been mindful of omissions that would require further primary legislation. In doing so, the draft Bill is viewed as a step forward in creating more legal certainty with regard to penalty clauses.

5. CORPORATE CONSIDERATIONS

- 5.1. Both the Corporate Procurement Team and Design Services were consulted due to their involvement with high value contracts that the Council enters into. Legal Services have also provided input in the form of analysing the proposed legislation.

6. RECOMMENDATIONS

- 6.1. The Committee is asked to approve the report and the Council's draft response to the Consultation, as detailed in Appendix 1 to this report.


Head of Legal Services

For further information on this report please contact June Murray on telephone 01698 302295.

Appendix 1

Response from North Lanarkshire Council Consultation on the Penalty Clauses (Scotland) Bill

Question 1

Are the benefits to business from clarifying the law in this area significant?

Yes.

Whilst the Council utilises liquidated damages clauses in certain contracts, it would be preferable to introduce more legal certainty with regard to penalty clauses. Specifically, there could be benefits as a result of section 1(2) of the draft Bill removing the requirement for a 'pre-estimate of damages' before a penalty clause is enforceable.

Question 2

Do you foresee any negative consequences from making all future penalty clauses enforceable subject to the safeguard of judicial control?

No.

It is recognised that legislation should not be retrospective with regard to any penalty clauses that have already be agreed. However, the Council may have reservations if all penalty clauses were subject to judicial control. Penalty clauses are taken to include irritancy clauses with regard to leases. It is noted that section 1(3)(a) of the draft Bill specifically excludes such irritancy clauses. Whilst the Council leases a significant amount of its property, it is recognised that, if irritancy clauses were included as part of the definition of penalty clauses, a more extensive review of legal provision with regard to leases could be required. This aside, the Council takes a positive view of making all other penalty clauses subject to judicial control.

It is noted that Article 9:509 of the Principles of European Contract Law require a penalty to be paid if there is non-performance in terms of the contract, with Article 1:301 defining 'non-performance' to include 'delayed performance, defective performance and failure to co-operate in order to give full effect to the contract.' Such an approach could lead to less certainty, particularly if it were alleged that there was a 'failure to co-operate'. It is noted that Article 9:509(2), in providing that a penalty 'may' be reduced, refers to 'loss resulting from the non-performance and the other circumstances' with no definition of what circumstances can be taken into account. This lacks legal certainty that the draft Bill seeks to address.

The 2004 edition of the UNIDROIT Principles of International Commercial Contracts adopts a similar approach in requiring payment to be made, in terms of Article 7.4.13, where there is 'non-performance'. By contrast, Article 7.1.1 defines 'non-performance' to include 'any' obligations under a contract, 'including defective performance or late performance'. This goes further than the Principles of European Contract Law. Article 7.4.13(2), in a similar manner to the Article 9:509(2) of the Principles of European Contract Law, provides that a penalty 'may' be reduced where 'the other circumstances' can be taken into account, again, with no definition of what those circumstances are.

However, the UNIDROIT Principles go further in recognising a penalty for 'any' obligations under a contract.

That the draft Bill introduces more legal certainty than either the Principles of European Contract Law or the UNIDROIT Principles of International Commercial Contracts is welcome. The reason for such support is that the draft Bill defines 'penalty clause' as 'any other clause' apart from an irritancy clause, where the 'substance' of the relevant clause includes 'breach of, or early termination of, the contract' with provision also made for what amounts to non-performance. By confining consideration of 'manifestly excessive' to the penalty clause is welcome, as otherwise the possibility of interference with other clauses in a contract may not be viewed as desirable. Section 1(4) introduces more certainty by defining circumstances that can be taken into account when determining if a penalty is excessive.

A consequence of greater certainty could stem from contractors being aware that penalties are enforceable after modification with the effect that contract prices could increase in order to make provision for such contingencies.

Question 3

Does the way in which the Bill is framed raise any concerns?

No.

Section 1(2) of the draft Bill is welcome due to removing any legal requirement for a pre-estimate of damages before a penalty clause is enforceable. Furthermore, by defining 'penalty' as 'a penalty of any kind' will permit consideration beyond strictly monetary considerations. This again is welcome. Section 4(1) only permits modification of a penalty to the extent that it is enforceable. This is also welcome, as the striking down of a penalty or a punitive penalty reduction could be viewed as undue interference in the freedom to contract principle. Furthermore, it is noted that the draft Bill does not make provision for secondary legislation. This again is welcome.

Question 4

What if any costs would you foresee the Bill imposing?

It is possible that parties to a contract may be less hesitant about seeking legal redress with regard to penalty clauses. This could increase costs. Furthermore, the draft Bill does not make provision for the enforcement of penalty clauses following a determination of whether or not a penalty is excessive. This could mean that an aggrieved party is faced with costs associated with a further application for penalty enforcement. Despite this, it may be expected that existing contract clauses in the form of each party bearing its own legal costs could be utilised. Furthermore, as section 4(1) permits a court to modify a penalty, any award of expenses that follows thereon may more particularly focus the minds of respective parties. Although this could contribute to the desired effect of ensuring that a penalty is not excessive when a contract is drafted and agreed, any imbalance in the bargaining position of respective parties to a contract may not alter significantly as a result of the draft Bill.

Question 5

Are there any comments on these or other aspects of the proposal you would like to make?

Overall, the draft Bill is welcome as greater legal certainty may permit the Council to give further consideration to the utilisation of appropriately drafted penalty clauses.