

ARE BANK CHARGES A PENALTY AT LAW AND UNENFORCEABLE?

In this paper the term “bank charge” refers to a charge levied by a bank against the account holder (the customer”) for breaching the agreed overdraft limit, or for becoming overdrawn where no overdraft facility has been agreed at all (i.e. a charge for a breach of contract as opposed to a service provided by the bank).

1.0 Background:

1.1 Bank charges continue to attract public scrutiny. It has been recently reported that banks were making over £ ½ billion a year from such charges.

“Millions of bank customers are being punished with ‘staggering’ penalty charges of an estimated £533 million a year”.

Source: Daily Mail 13 January 2006 page 35.

1.2 The above article is but one of many that I located recording growing concern at bank ‘penalty’ charges being levied against customer’s accounts (and also their considerable increase in amount). Critics argue that these are abused by the banks to create a significant source of profit rather than, as they should, seeking to be a genuine estimate of their actual loss likely to be incurred by the customer’s breach. It is to be remembered that this bank charge is not for the recovery of the overdrawn sum, or interest thereon, but purely a charge levied for what should only be the banks associated administrative charges.

1.3 Many people have at some time inadvertently gone over their overdraft limit, with the result that considerable charges are applied to their accounts. Bank charges for bounced payments and late payments on credit facilities can typically be between £25 and £39 (see below). Several bounced cheques, say over a busy Christmas Period could result in multiple charges being applied exceeding £100.

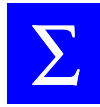
1.4 Moneyfact’s lists the charges (at October 2005)¹ as follows:

Bank overdrafts					
	Penalty fee for busting limit	Insufficient Funds (item paid)	Insufficient Funds (item bounced)	Overdraft interest rate (authorised)	Overdraft interest rate (authorised)
Halifax	£28	£30	£39	18.9%	29.8%
Lloyd’s TSB	£30	£30	£35	18.2%	29.8%
Natwest	£28	£30	£38	17.7%	29.7%
Barclays	Nil	£25	£30	15.6%	27.5%
HSBC	Nil	£25	0-£30	14.8%	14.8%

2.0 Liquidated Damages or Penalties.

2.1 I do not intend to do a detailed review of the history and case law related to penalties. Rather I set out below legal principles that are derived from them.

¹ Abstracted from Daily Mail, January 13, 2006 at page 35.



2.2 Damages for breach of Contract.

2.2.1 It is a well established legal principle that where a party (the “innocent party”) sustains a loss caused by a breach of contract by the other party to the contract (the “defaulting party”), the innocent party is, so far as money can do it, entitled to be placed in the same situation, via the payment of damages incurred, as if the contract had been performed (i.e. no breach)².

2.2.2 When a customer opens an account with a bank their relationship is founded on a contract, governed, *inter alia*, by contract law. The customer agrees to maintain sufficient funds in his account (or an agreed overdraft facility) in order to pay any sums drawn against it e.g. direct debits, cheques. Where the account does not have sufficient funds to meet such payments the customer commits a breach entitling the bank to damages for any loss caused, for which the bank charges a fee (i.e. a bank charge).

2.3 Liquidated Damages

2.3.1 A party can sue for its actual loss caused by a breach of contract by way of legal proceedings – this is known as damages.

2.3.2 Alternatively, a contract may provide for a pre-determined specified sum of money to be payable by the defaulting party following a breach of the contract (“a “liquidated damages” clause) – this is known as liquidated damages.

2.3.2 One advantage of a liquidated damages clause is that the innocent / non-defaulting party can recover damages without incurring the difficulty and expense of proving the actual damage. This option is likely to be attractive to the banks where the damages incurred are likely to be small amounts.

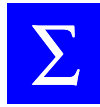
2.3.3 However, the law requires that the liquidated damages sum must be a genuine pre-estimate of the loss or damages incurred by the innocent party. If it is not then the term will be construed as penal and, as a penalty clause, it will not be enforced by the courts.

2.4 What is a penalty clause?

2.4.1 In the leading well-known case of *Dunlop Pneumatic Tyre Co. Ltd. v New Garage & Motor Co. Ltd.* [1915] A.C. 79 at 86., it was noted that a clause is penal if it provides for “a payment of money stipulated as *in terrorem* of the offending party”, (i.e. a payment of a sum of money intended to frighten or intimidate the offending party rather than a genuine attempt to compensate the innocent party for their actual loss).

2.4.2 A clause that is found to be penal (i.e. a penalty clause) is generally invalid, and it is an unusual feature of the law of contract that the court will strike down penalty clauses, whilst (usually) permitting other clauses which have been freely agreed between the parties even if those clause are unduly harsh.

² Robinson v. Harman (1848) 1 Ex. 850 at 855



2.4.3 It is sometimes a matter of some difficulty to determine whether liquidated damages clauses are, in the particular circumstances of the case, penalties or liquidated damages, but the principles applied by the courts are well established.

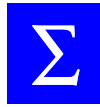
2.4.4 In the above noted case of *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited*, Lord Dunedin set out a series of propositions in respect of Penalty clauses, which have often been cited and relied upon for the last 90 years. These propositions being:-

1. Even though the parties may use the word 'penalty' or 'liquidated damages' in respect of a clause, it is for the Court to find out whether the payment stipulated is in truth penalty or liquidated damages.
2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party.
3. The essence of liquidated damages is a genuine covenanted pre-estimate of damage.
4. The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of making the contract, not as at the time of the breach.
5. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration, may prove helpful, or even inclusive. Such tests being:-
 - (a) It will be held to be a penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.
 - (b) There is a presumption (but no more) that it is a penalty when, 'A single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.'
 - (c) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimate damage was the true bargain between the parties.

2.5 Further recent guidance

2.5.1 Mr Justice Jackson in the recent case of *Alfred McAlpine Capital Projects Limited v Tilebox Ltd*³ had to consider whether a clause was a penalty in a dispute between two commercial organisations. Having considered the relevant authorities, at paragraph 48 of his judgment he made the following four general observation pertinent to that case:-

³ *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] EWHC 281 (TCC)



- “1. *There seem to be two strands in the authorities. In some cases judges consider whether there is an unconscionable or extravagant disproportion between the damages stipulated in the contract and the true amount of damages likely to be suffered. In other cases the courts consider whether the level of damages stipulated was reasonable. In my view, a pre-estimate of damages does not have to be right in order to be reasonable. There must be a substantial discrepancy between the level of damages stipulated in the contract and the level of damages which is likely to be suffered before it can be said that the agreed pre-estimate is unreasonable.*
2. *Although many authorities use or echo the phrase "genuine pre-estimate", the test does not turn upon the genuineness or honesty of the party or parties who made the pre-estimate. The test is primarily an objective one, even though the court has some regard to the thought processes of the parties at the time of contracting.*
3. *Because the rule about penalties is an anomaly within the law of contract, the courts are predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power.*
4. *Looking at the bundle of authorities provided in this case, I note only four cases where the relevant clause has been struck down as a penalty.... In each of these cases there was, in fact, a very wide gulf between a) the level of the damages likely to be suffered, and b) the level of damages stipulated in the contract.”*

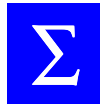
2.5.2 Based upon the above, and the circumstances of that case, Mr Justice Jackson formed the view that the liquidated damages clause in question was not a penalty clause, and therefore would be enforced.

2.5.3 This latest case appears to emphasise that a court will be slow to interfere with a liquidated damages negotiated at arms length between two commercial parties. This was particularly relevant in this case, given that the liquidated damages provisions survived heavy negotiation. It further appears that the courts will not be persuaded by arguments that the actual loss suffered is less than the estimated damages, unless the discrepancy is so large that it demonstrates that the sum could not have been a genuine pre-estimate of the likely loss but was unreasonable.

2.6 Consumers

2.6.1 However, whether the courts would be slow to interfere and/or reach the same conclusions in respect of a liquidated damages clause unilaterally (not negotiated) inserted by a large commercial organisation into a contract with a consumer is unclear. It appears that this is a one relevant factor considered by the Australian Courts when examining this issue:

“[t]here is, in my view,, a qualitative difference of which the law is able to take into account between a clause freely negotiated between a major commercial organisation, in respect of a substantial contract, where the major commercial organisation have available and receive competent legal advice regarding the meaning, purpose and likely consequence of the clause, from a clause attacked in a



contract of adhesion between a major organisation and a individual or small company who has, in reality, no opportunity to negotiate the contract”⁴

“[t]hat is not to say that the latter form of contract containing such a clause would be struck down; it is rather to recognise that, quite apart from whether the clause fails because it lacks a compensatory character, it may also fail because a being imposed in the circumstances rendering enforcement of the clause unconscionable. The degree of contractual freedom afforded to parties to determine a measure of damages departing from strict compensation will, in my view, be affected by those matters constituting aspects of the relationship ...”

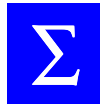
- 2.6.2 From the above, it may be the background relationship between the contracting parties (i.e. their relative bargaining position and whether or not there was an opportunity to negotiate a term) could possibly be one of the factors considered by the courts in determining whether a sum is a penalty or not. However, this not clear and it may be that this is not considered by the courts at all. However, if it is, then it is likely that an individual consumer may be viewed more favourably by the courts than a large company. Regrettably, the absence of any legal precedent established by case law for bank charges means that no definite conclusion can be reached.
- 2.6.3 However, in either event, irrespective of the parties standing (an individual or a company) arguments that the bank charge was not a reasonable estimate of the banks likely loss, but was far greater and disproportionate would still have to be considered.

3.0 Bank Charges

- 3.1 It is not disputed that a bank is entitled to damages (reimbursement of its direct actual costs) following a breach of contract by a customer, and it is entitled to include a liquidated damages clauses to cover specified breach by its customers. A penalty is however unenforceable.
- 3.2 To decide whether a bank charge is a penalty or is liquidated damages the likely costs incurred by the bank needs to be examined to establish whether or not the banks charge represents a genuine attempt at pre-estimating its likely loss caused by the customer’s breach.
- 3.3 In a recent study undertaken in Australia⁵ it was estimated that the cost of processing a dishonoured cheque by an Australian Bank was (generously) likely to be in the region of \$3.00 to \$6.00. A direct debit dishonour was estimated to be in the likely region of 54 cents. No data was published by the Australian banks to confirm or deny this. By reviewing the banks’ charges against the above figures, the study estimated that banks could be charging:
- a. between 5 to 16 times what it costs them to process a cheque dishonour.
 - b. between 64 to 92 times what it costs them to process a direct debit dishonour.
- 3.4 The study’s key findings stated that in its opinion the Australian Bank’s cheque and direct debit dishonour fees (bank charges) were likely to be penalties at law.

⁴ Cole J in *Multiplex Constructions Pty Ltd v. Abgarus Pty Ltd* (1992) 33 NSWLR 504

⁵ Nicole Rich, “*Unfair fees: a report into penalty fees charged by Australian Banks*”

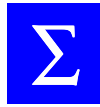


- 3.5 Further in an American study⁶ (also referred to in the above Australian study) it had been estimated that the American's Banks' cost to process a dishonoured cheque was between US\$ 0.50 and US\$1.50 (estimated actual cost being 11 to 32 times less than the bank's actual charge). To process a dishonoured direct debit payment was between US\$0.48 and US\$0.65 (estimated actual cost therefore being 9 to 11 times less than the banks' actual charge).
- 3.6 Unfortunately I could find no similar research for the United Kingdom's Banks. Further, as far as I am aware (perhaps for obvious reasons), the United Kingdom Banks do not publish any details to support how their bank charges are calculated, nor what their actual costs associated with such breaches are, nor what revenue they derive (after actual costs) from such bank charges.
- 3.7 Therefore, whilst regrettably I am unable to do anything other than speculate, given the findings reported in the American and Australian studies, and the use of computer automation, apparently similarly employed by the banks in the United Kingdom, it is difficult to reconcile how a bank can incur costs of £25 to £39 in the process of:
- a. sending a computer generated letter if a customer exceeds authorised overdraft limit (even by a minor amount) to advise the customer of the breach and resultant charges, or
 - b. returning a dishonoured cheque plus notice to the customer, or
 - c. the non payment of a direct debit.
- 3.8 Such charges may therefore be found to be a "penalty" if the matter went to court. However, under the rule of law, the burden of showing that the clause is a penalty clause would rest with the person bringing the proceedings (i.e. the customer").
- 3.9 However, I understand that in most instances the need to pursue such matters via proceedings is unnecessary. The banks often "waive" their charges following customer's threats to "vote with their feet". Another reason is that the vast majority of people are unaware of their legal position, or even if they are, and the banks do not "waive" their charges, they are naturally reluctant to incur the time, trouble and expense of embarking on legal proceedings for a relatively small amount.

4.0 Summary:

- 4.1 A penalty clause does not seek to compensate the innocent party for his actual loss, but rather it seeks penalise the defaulting party. Such clauses are not enforceable.
- 4.2 Whether a clause is a penalty clause is a question of construction of the contract, to be determined at the date of the contract, and not at the date of the breach.
- 4.3 A court is likely to uphold a liquidated damages clause to the extent that it is satisfied that, at the time of the contract, the specified sum was a reasonable estimate of the probable loss flowing from the breach that would be incurred by the innocent party.

⁶ 1998 American Study on cheque dishonour fees by the Consumer Federation of America "*Bounced Cheques : Billion Dollar profits II*".



- 4.4 The courts are likely to construe a term as a penalty where the predetermined sum to be paid is wholly disproportionate or extravagant, exorbitant or unconscionable in comparison with the probable loss suffered by the innocent party (at the time of the contract).
- 4.5 There could be a difference in the approach of the court between a claim brought by an individual consumer to that of a company, but this is unclear.
- 4.6 Whilst not analysed in any detail, bank charges do, *prima facie*, appear disproportionate and excessive.
- 4.7 If the matter progressed it may therefore be that bank charges would be found to be a penalty, and unenforceable, but this would depend on the circumstances of the case.
- 4.8 However as with all proceedings, this result cannot be guaranteed. These issues have never been tried and tested in a court of law, hence there is no legal authority established by precedent. Further, there is no data available from the United Kingdom banks in order to determine how the various bank charges have been calculated.
- 4.9 Finally where the bank account is a consumer contract, excessive bank charges (if found to be the case) may also be in breach of the Unfair Terms of the Consumer Contracts Regulations 1999. I also understand that the Office of Fair Trading Office has recently ruled that credit card charges of up to £25 for people who were late in making payments, or who exceeded credit limits, were unfairly heavy sums, and have also threatened to also investigate the validity of bank charges already made.
- 4.10 Individual customers are deterred from taking the matter to court because of the legal and other costs involved in dealing with relatively small individual amounts in dispute. The corollary to this being that if many thousands of individual cases were taken against the banks, the banks would suffer huge legal and other administrative costs in defending such claims. Anecdotal evidence shows that those people that do object to the banks' charges frequently have the charges withdrawn as a "gesture of goodwill" – but perhaps, taking a more cynical view, the withdrawal of the charges may have more to do with the banks' desire not to have the matter tested in court rather than anything to do with goodwill.

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