CRUNCHING CREDIT AGREEMENTS: FORMS, FORMALITIES AND REFORMATION IN CONSUMER CREDIT PRACTICE

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THE CONSUMER CREDIT ACT: PITFALLS AND PRACTICALITIES

Introduction

1. The Consumer Credit Act 1974 is a comprehensive and prescriptive Act which regulates personal credit and hire agreements entered into between lenders and consumers. The Act regulates all stages of a personal credit transaction from advertising of the relevant facility; the pre-contract negotiations; the mode of entry into and execution of the relevant credit or hire agreement; the form and content of the agreement; rights of cancellation and withdrawal; the supply of information and copy documents; matters arising during the lifetime of the agreement; right through to procedures on default, termination and modes of enforcement.

2. The Consumer Credit Act 1974, (the **"1974 Act"**) was amended, quite substantially, by the Consumer Credit Act 2006, (the **"2006 Act"**). In these notes however, a reference to the **"CCA"** is a reference to the 1974 Act, as amended by the 2006 Act.

3. One of the fundamental problems which arose with respect to the 1974 Act was that, due to its age, it did not accommodate modern financial services practice and market demands. Indeed many of the products and facilities which, over time, fell to be regulated by the 1974 Act (such as credit cards) were not in widespread use or circulation at the time of drafting. Equally, under the 1974 Act there was (for obvious reasons) no facility to contract online. Consequently the 2006 Act was enacted, but the extent to which it has addressed some of the key concerns arising from the 1974 Act is a moot point.

4. Nevertheless, by way of introduction, it is worth revisiting the types of facility which are regulated by the CCA. Whilst many agreement types such as personal loans and credit cards are obvious, it is necessary to consider those less obvious facilities which also fall to be regulated by the CCA.

What types of facility are covered by the CCA?

5. The CCA regulates credit and hire facilities to individuals, regardless of the amount of credit. Under the 1974 Act, only facilities where the amount of credit was £25,000 or less were regulated by the Act. Above that threshold, the relevant agreement was outside the ambit of the 1974 Act. One of the reforms of the 2006 Act was to abolish the financial threshold[1] so that all facilities made available to individuals, regardless of amount, were potentially regulated by the CCA.

6. It is not possible to contract out of the CCA[2].

7. Under the CCA, "individual" is a defined term[3] which extends beyond just natural persons. An individual for the purposes of the CCA is:

    a. a natural person;
    b. an unincorporated association; or
    c. a partnership comprising three partners or fewer, where not all the partners are bodies corporate, ("small partnerships").

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[1] S.8(2) 1974 Act was repealed on 6th April 2008 by the 2006 Act, the effect being to abolish the old £25,000 financial limit for regulation.
[2] S.173(1) CCA
[3] S.189(1) CCA, introduced by the 2006 Act

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8. Having considered the borrowers who are entitled to the protections of the CCA, it is necessary to examine briefly what is meant by the term “credit”.

What is credit?

9. “Credit” for the purposes of the CCA includes a cash loan and any other form of financial accommodation[4]. This statutory definition is widely cast and effectively captures not only credit facilities as currently comprehended, but also any new forms of facility which may be devised. In considering the breadth of this statutory definition which captures credit facilities as they evolve with developing financial services markets, it is easier to understand how other provisions of the CCA have failed to keep pace with evolving markets and products.

10. The statutory definition of credit involves two basic concepts. The first is straightforward lending by way of a cash advance. The second relates to making a financial accommodation which may be comprised in some type of revolving or running account facility (such as a credit card facility, or a revolving loan) or otherwise, the deferral of what would be an immediate obligation to pay for goods and services.

11. The concept and meaning of “credit” for the purposes of the CCA was considered in *Dimond v Lovell* [2000] 1 Q.B. 216; [1999] GCCR 2302 CA; [2001] GCCR 2751; [2000] 2 WLR 1121 HL. This case concerned car hire charges in circumstances where a driver, whose car had been damaged by a third party, hired a substitute car from a firm which then pursued the third party at fault for the damage to the driver’s car. Under the terms of the agreement between driver and hire firm, the driver was not liable to pay for the hire car charges if the hire firm recovered monies, by way of damages, from the third party and in any event, the driver was not liable to pay anything pending the outcome of the action for recovery.

12. The debate and consideration in *Dimond v Lovell* was extensive and detailed, but for present purposes, it is worth noting a list of the constituent parts of credit (originally composed by Professor Goode in Consumer Credit Law and Practice[5]) which was approved by the Court of Appeal:

    a. The supply of a benefit;
    b. Attracting a contractual duty of payment;
    c. In money;
    d. The duty to pay being contractually deferred;
    e. For a significant time after payment has been earned;
    f. Such deferment being by way of financial accommodation.

13. As noted above, contractual deferment of the obligation to pay is a key ingredient of credit. In the absence of a contractual deferment of a debt, there is no credit.

Types of Agreement

14. Many types of credit agreement are readily recognisable: cash loans; “personal” loans; credit cards; store cards (where running account credit is available); hire purchase agreements; conditional sale agreements (most commonly used to finance the purchase of motor vehicles); and hire and lease facilities where capital expenditure is financed by spreading the cost over a term of years.

15. However, due to the breadth of the definition of credit, coupled with the composition of those who qualify as individuals for the purposes of the CCA, some less obvious facilities might fall to be regulated by the CCA. A few examples are set out below:

[4] S.9(1) CCA
[5] Goode, Ed.: Consumer Credit Law and Practice, para 24.18.

a. a hire purchase agreement entered into by a small partnership in order to finance the acquisition of IT equipment for the partnership office;
b. a golf club entering into lease finance arrangements in respect of lawn mower equipment;
c. an NHS trust entering into lease finance arrangements in respect of grounds care equipment;
d. a loan made to a natural person in a principal amount of £1,000,000 to enable the borrower to participate in an investment opportunity;
e. a loan made to a professional person to enable them to buy into their professional practice as a partner;
f. a loan made to a natural person secured by a second charge over their home.

16. The starting point is that where credit is made available to an individual, the CCA potentially applies, as is illustrated by the example list of facilities above. The next step is to consider whether there are any available exemption categories under the CCA[6]. If an exemption category is available, then it operates to exempt the entire agreement and transaction from the controls of the CCA[7], save for the provisions of the CCA relating to unfair relationships[8], (which are discussed in detail below).

17. A common misconception which frequently arises with regard to the CCA is that because the Act is concerned with personal credit agreements, it does not regulate agreements entered into for business purposes. This is not the case. The CCA does regulate entered into for business purposes, where the borrower or hirer is an individual. There is a "business purposes" exemption category which is available in certain circumstances and which operates to exempt the relevant agreement from the provisions of the CCA. We shall now turn to the topic of exemption categories.

Exemption categories

18. The 2006 Act introduced two new exemption categories which are worth considering in the context of the less obvious facilities which fall to be regulated by the CCA.

19. The first potentially helpful exemption category is the "business purposes" exemption[9]. This exemption category provides that the CCA does not regulate a consumer credit agreement[10] under which the creditor provides the borrower with credit exceeding £25,000, if the agreement is entered into by the borrower or hirer wholly or predominantly for the purpose of a business carried on by him.

20. The relevant agreement shall be presumed to have been entered into wholly or predominantly for business purposes if it contains a declaration to that effect by the borrower or hirer[11]. However, this presumption does not apply if the lender or any person acting on behalf of the lender in connection with the entry into the agreement knows or has reasonable cause to suspect that the agreement is not entered into by the borrower or hirer wholly or predominantly for the purposes of a business carried on by him[12].

21. The form and content of the required declaration of business purposes is prescribed under the CCA and must be included in the prescribed form in the body of the relevant agreement[13]. It is a curiosity of the operation of the CCA that an agreement expressed to be exempt from the provisions of the Act on "business purposes" grounds is nonetheless subject to the controls of the Act as regards the form and content of the relevant declaration contained in the agreement.

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[6] S.16 CCA
[7] S.8(2) and s.16 CCA
[8] S.140A – s.140D CCA
[9] S.16B CCA
[10] A consumer credit agreement being an agreement between an individual and a creditor pursuant to which credit of any amount is provided, s.8(1) CCA
[11] S.16B(2) CCA
[12] S.16B (3) CCA. The provisions of s.16B(3) are anti-avoidance provisions designed to prevent unscrupulous lenders deliberately signing up borrowers on "business purposes" agreements as a means of contracting out of the CCA.
[13] Schedule 3, Consumer Credit (Exempt Agreements) Order 2007.

22. The key point to note is that it is not sufficient simply to rely on a factual assertion that the relevant credit or hire agreement is for business purposes. In order to qualify for the exemption under s.16B CCA, the agreement must contain a declaration, in the prescribed form, signed by the borrower or hirer. Otherwise, if the agreement was defective in this regard, it would be unenforceable against the borrower or hirer without a Court Order on the basis that it did not conform to the strict rules of the CCA regarding the form and content of regulated agreements[14].

23. The second potentially useful exemption category introduced by the 2006 Act is the exemption available to high net worth borrowers and hirers[15]. This exemption is available to borrowers or hirers who are natural persons only[16] and so excludes the other categories of "individual". The exemption is available where:

    a. the relevant agreement includes a declaration by the borrower or hirer that they are prepared to forgo the protection and remedies that would otherwise be available to them under the CCA;
    b. a statement of high net worth has been made in respect of the borrower or hirer;
    c. the statement of high net worth is current and has been provided to the lender before the agreement was made.

24. The level of income and assets required to cause a borrower to qualify as "high net worth" is prescribed, along with the form of declaration to be made by the borrower and the form of the certificate to be provided by an accountant. As with the business purposes exemption, it is not sufficient simply to rely on a factual assertion that the relevant borrower or hirer is a high net worth individual. The strict requirements of the CCA must be complied with in order for the exemption category to be available.

UNFAIR CREDIT RELATIONSHIPS

Background

25. The 2006 Act has introduced a new statutory weapon to enable an individual debtor to attack any credit agreement where the relationship between the creditor and the debtor arising out of and relating to the agreement has in any way given rise to "unfairness" detrimental to the debtor. The new statutory provisions have been in full force for only just over a year, and their full power has yet to be unleashed, at least at appellate court level. They will however open up to scrutiny the whole course of dealing between a creditor and an individual debtor, albeit that the foundation of the relationship, and so of any unfairness, remain the terms of the agreement itself.

26. "Transparency" and "fairness" were the legislative buzz-words providing the broad justification for many of the new provisions and concepts contained in the 2006 Act. Lord Sainsbury, the promotor of the Bill in the House of Lords, put it this way:

    > *"We need to drive out irresponsible lending, not only to protect consumers, but also to ensure that credible businesses can operate with confidence in a competitive market. We also want to empower consumers to make informed borrowing decisions. This relies on transparency and clarity of agreements with lenders, and on consumer confidence in appropriate levels of rights and redress."*[17]

27. It was considered that high levels of personal indebtedness were occurring because U.K. consumers simply did not understand, in advance of agreements or during their currency, the consequences of default. Whether this assumption was well-founded, the legislature took the view that the burden ought to be placed on creditors to ensure that the relationship with the consumer debtor became open, transparent and fair: the more transparent the relationship, so the logic appears to run, the less likely consumers were to fall into and continue to suffer damaging levels of debt. The 2006 Act responded to these social concerns in a number of

[14] See s. 61(1)(a) CCA; s.65(1) CCA
[15] S.16A CCA
[16] S.16A(1)(a) CCA
[17] Hansard, 24th October 2005, Col. 1026.

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ways, ranging from the formalistic (e.g. a requirement that debtors be notified when they default) to the radical. Perhaps most far-reachingly, the much-maligned provisions for the re-opening of extortionate credit bargains were repealed wholesale as from 6th April 2008, and a new system for judicial control of unfair relationships between creditors and debtors came into force.

28. The 1974 Act empowered courts to re-open "extortionate credit bargains" (the old s.137 to s.140 of the 1974 Act), defined as bargains which required the debtor to make payments which are "grossly exorbitant" or otherwise "grossly contravene[d] ordinary principles of fair dealing". Importantly, and in a clear distinction to the new "unfair relationship" provisions, the extortionate credit bargain test was agreement-focused, not relationship-focused. The debtor's attack under the old provisions was on the terms of the agreement and not on the manner in which the creditor had acted save as illustrated or defined by those terms. Although the provisions were not limited to agreements otherwise regulated by the 1974 Act (allowing any individual debtor under a credit agreement to argue, in principle, that the agreement was extortionate), the hurdle was extremely high for the debtor: the debtor had to show that the payments required by the agreement were *"grossly exorbitant"* or that the bargain *"otherwise grossly contravene[d] ordinary principles of fair dealing"* (s.138(1)). Unsurprisingly, these tests were rarely passed, and the courts were slow to intervene. By 2006, the anachronistic extortionate credit bargain provisions had largely fallen into disuse.

29. The 2006 Act repealed the extortionate credit bargains provisions in their entirety, and introduced new provisions to provide consumers with a broad right to challenge "unfair" credit relationships (the new s.140A to s.140D). The "unfair relationships" provisions of the 2006 and 1974 Acts ought to be viewed as part of an overlapping regime of consumer contract protection in which the concept of "unfairness" looms large: see the Unfair Terms in Consumer Contracts Regulations 1999 ("**the 1999 Regulations**") and the Consumer Protection from Unfair Trading Regulations 2008. What makes the "unfair relationships" test unique in this armoury is that its protection is not limited to consumers in a traditional sense, but extends to all statutory individuals who have entered into agreements which provide credit in any form. Thus as will be seen even debtors who have purchased credit for commercial (or "business") purposes may be able to take advantage of the new provisions.

Gateways

30. The court has no power to invoke the new provisions of its own initiative. They may be invoked only by a debtor or surety to a credit agreement, and only (i) on an application by the debtor or surety, (ii) at the instance of the debtor or surety in any proceedings to which the debtor and creditor are parties and which concern the enforcement of the agreement or a related agreement, or (iii) at the instance of the debtor or surety in any proceedings where the amount paid or payable under the agreement or a related agreement is relevant: s.140B(2).

Ambit

31. Section 140A(1) and (2) now determine the circumstances in which courts may intervene in unfair relationships as follows:

> *"(1) The court may make an order under section 140B in connection with a credit agreement if it determines that the relationship between the creditor and the debtor arising out of the agreement (or the agreement taken with any related agreement) is unfair to the debtor because of one or more of the following-*
>
> *(a) any of the terms of the agreement or of any related agreement;*
>
> *(b) the way in which the creditor has exercised or enforced any of his rights under the agreement or any related agreement;*
>
> *(c) any other thing done (or not done) by, or on behalf of, the creditor (either before or after the making of the agreement or any related agreement).*

(2) In deciding whether to make a determination under this section the court shall have regard to all matters it thinks relevant (including matters relating to the creditor and matters relating to the debtor)."

32. The new provisions have applied to new credit and related agreements with individual debtors[18] since 6th April 2007, and since 6th April 2008 have applied to all such agreements, whenever they were made. A "credit agreement" is defined as *"any agreement between an individual (the 'debtor') and any other person (the 'creditor') by which the creditor provides the debtor with credit of any amount"* (s.140C(1)). In turn "credit" is defined by s.9 of the 1974 Act as including a cash loan, *"or any other form of financial accommodation"*, as well as finance by way of hire-purchase.[19]

33. The definition of credit does not, however, include asset finance by way of a pure lease or hire of goods, and accordingly (if anomalously) hire agreements are not within the ambit of the "unfair relationships" provisions.[20]

34. Thus the unfairness test applies to almost any credit agreement providing credit of any amount to an individual debtor, including lending to high net worth individuals and lending for business purposes.[21] The only exclusion is in respect of FSA-regulated mortgage contracts (s.140A(5)), although second mortgages will be caught.

35. The provisions also extend to any "related agreement", which is defined as any agreement that is consolidated by the main agreement, is a linked transaction to the main or consolidated agreement, or is security provided in relation to the main agreement, a consolidated agreement or a linked transaction (s.140C(5) to (7)).

36. Therefore, on the application or at the instance of a debtor or surety for an order, the court will be required to consider the fairness (or otherwise) of the agreement and of the ongoing relationship between creditor and debtor as a whole: "anything done (or not done) by or on behalf of the creditor".[22] As is typically the case in consumer protection legislation, the creditor bears the burden of disproving unfairness once an allegation of unfairness is made.

37. The court's powers under s.140B will be available wherever the court determines that the relationship between creditor and debtor is "unfair" with respect to one or more of the three matters set out in s.140A(1)(a) to (c): i.e. any of the terms of the agreement (or a related agreement), the way in which the creditor has sought to enforce its rights and any other thing done or not done by the creditor before or after the making of the agreement or any related agreement.

38. The three matters which may be adjudged unfair are not mutually exclusive; indeed, the third category is something of a catch-all and would almost certainly include the second in any event. They are however mutually supporting: even if the terms of an agreement are not sufficient in themselves to give rise to statutory unfairness, the relationship arising out of those terms may become unfair by reason of the acts or omissions of the creditor in relation to the terms.

39. Thus the ambit of s.140A is wide indeed: the court is invited to thrash through the undergrowth of the entire history of the relationship between creditor and debtor in a potentially time-consuming and expensive determination of "unfairness". The only statutory guidance given to the court is set out in s.140A(2): it must have regard to all matters it thinks relevant.

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[18] Which is a statutory concept. The word "individual" includes natural persons, partnerships made up of two or three people, and unincorporated associations not made up entirely of bodies corporate: s.189.

[19] In *Maple Leaf Macro Volatility Micro Fund v Rouvroy and Trylinski* [2009] EWHC 257 (Comm). [2009] 2 All ER (Comm) 287, Andrew Smith J approved the analysis of Sir Roy Goode in Consumer Credit Law and Practice that credit involves the supply of a benefit to the debtor with the obligation to pay being *contractually* deferred. If there is no duty to pay, or if there is no consideration for the deferment of payment, there is no credit (albeit that this may not be altogether easy to reconcile with *Dimond v Lovell* [2000] QB 216 at [54]).

[20] This anomaly is repeated in other parts of the 1974 Act: see for instance the liability of the creditor for the acts of the supplier where there have been negotiations, where the liability arises only where the resulting agreement is a credit agreement as defined above.

[21] Because the protection applies to "credit", not "consumer credit", agreements.

[22] Including, it would appear, a decision to terminate the agreement.

Unfairness

40. Other than the nebulous concept of "relevance", there is no guidance in the 2006 Act itself as to what is meant by the critical term "unfair" and the Government quite deliberately refused to provide any other guidance as to what this term is intended to mean. The OFT has published non-binding guidance on unfair relationships and its powers under Part VIII of the Enterprise Act 2002,[23] paragraph 3.13 of which contains the telling comment that *"[i]t is … not possible, in advance of any cases decided by the courts, for the OFT to provide guidance on the meaning of the test or how it is likely to be applied by the courts."* The OFT says that in considering whether to use its enforcement powers, it will look to whether contract terms comply with the 1999 Regulations and the Unfair Contract Terms Act 1977, and that it will take into account the rules and principles under which the FSA is expected to regulate the financial sector. This is about as far as the OFT is prepared to go: it has expressly adopted the position that it can give no more firm guidance until the courts have had cause to consider the new test.

41. A definitive ruling may, however, be some time off. Creditors have proven reluctant to fight all but the most unmeritorious allegations of unfairness to trial. Although the "unfair relationships" provisions have been in force for new agreements since April 2007 and for all agreements since April 2008, there has to date been only one reported case in which the provisions have been considered in any detail at all, and even then the analysis was strictly *obiter*.

42. The facts of *Maple Leaf Macro Volatility Micro Fund v Rouvroy and Trylinski* [2009] EWHC 257 (Comm). [2009] 2 All ER (Comm) 287 were about as far removed as it is possible to get from the typical "consumer" credit matter. The case concerned a claim by a Cayman Islands hedge fund and an investment manager against the defendant investors for breach of a funding agreement by reason of their failure to transfer certain warrants to a special purpose vehicle which was intended to stand as security for repayment of funding advanced by the first claimant.

43. Among a plethora of other arguments, the defendants contended that the interest and risk elements of the funding agreement created an unfair relationship. Andrew Smith J rejected the submission that the "unfair relationships" provisions were even applicable: the funding arrangement did not involve the provision of "credit" (i.e. there was no contractual deferment of a debt or obligation to pay for a benefit conferred, merely a fee payable on a later date) to the defendant individuals.

44. Nevertheless, the court went on to analyse the 1974 Act (as amended) on the assumption that there were a credit agreement at issue. The analysis is of some interest. At paragraph 283, Andrew Smith J noted that *"it is not sufficient for the creditor to show that it was fair in the way in which it went about reaching an agreement with the debtor. The question of the fairness of the relationship between creditor and debtor calls for a different enquiry from that required by the 1999 Regulations...."* (paragraph 283). Thus the OFT may be right to consider that the 1999 Regulations are a relevant source of guidance for the meaning of unfairness, but it is clear that a finding of unfairness (or otherwise) under the earlier legislation is not in any way definitive of the fairness of a credit agreement for the purpose of s.140A. The court accordingly underlined that the approach required by the new regime is not simply agreement-focussed; the unfairness is located in the relationship, which may be illustrated by the terms of the agreement but is a much wider concept.

45. The principal analysis of s.140A in *Maple Leaf* concerned the question of whether the terms of the agreement per se created an unfair relationship. Specific criticism was made by the defendants of the provisions as to return on the funding (said to be excessive), the personal undertakings required by the hedge fund (which were said to be excessive and unwarranted), the default provision (which allowed the fund to retain the collateral provided by the defendants without requiring any similar collateral to be provided by the fund), the termination provision (which was attacked as effectively penal) and the securities lending provision.

[23] Available at http://www.oft.gov.uk/shared_oft/business_leaflets/enterprise_act/oft854.pdf.

46. Andrew Smith J's approach is informative. He noted that *"the defendants created the circumstances in which they had to resort to expensive funding, were warned explicitly ... that it would be expensive and accepted an increase in the cost of the funding... I am unable to accept that, especially given the defendants were experienced businessmen, this in itself means that the terms were unfair"* (paragraph 287). In other words, the "credit" (if it was such) was expensive because that was precisely what the defendants had asked for; in the context of this agreement, the court's analysis of everything of "relevance" included analysis of the defendant's own experience in the market. On the facts of the case, insofar as the defendants complained that they entered into the funding agreement in a frenetic atmosphere where the effect of the agreement was not properly considered by them, this was caused by the defendants' own failure to call upon the claimants' services until very late in the private placements.

47. His Lordship also rejected an analysis of the other impugned terms as unfair, largely on the basis that the risk to the "lender" when compared to the defendants' exposure to risk justified the imposition of more-onerous-than-normal requirements on the defendants. The two key factors appear to have been (i) the defendants' choice to purchase a facility which they knew and expected would be expensive, and (ii) their experience in and knowledge of the relevant market. Taken together, they led the court to reject the allegation of unfairness in a situation in which the defendants obtained exactly what they bargained for. Whether the analysis will allow rejection of the allegation of unfairness in a pure consumer market for obviously expensive products (e.g. bridging loans) remains to be seen, but it is to be hoped that the courts will not be slow to reject allegations of unfairness raised for expensive but otherwise unobjectionable loans made in high-risk and therefore expensive markets.

48. The court also roundly rejected the defendants' contention that the termination and security lending provisions were unfair because the claimants *might*, although they did not, go on to exploit them unfairly. Again the analysis is of interest: *"There would have been adequate power under the regime in section 140A et seq of the 1974 Act for the court to make an order in the event that the claimants unfairly exercised these rights, and I do not accept that, even if these provisions might have been exploited unfairly, the court should make any relevant order in the circumstances that have occurred"* (paragraph 290).

49. A distinction is drawn between terms which per se create an unfair relationship, and those which are neither fair nor unfair (fairness-neutral) but which may create unfairness if enforced in a particular way. A more day-to-day example may be a provision in a loan agreement pursuant to which the time for payment is made of the essence (so in principle entitling the creditor to terminate the agreement and call in the balance if the debtor is a day late on one occasion): the condition as to time is on the face of it neither fair nor unfair, but in appropriate circumstances it may be argued that the term is enforceable in such a way as to render the effect on the debtor unfair.

50. Andrew Smith J's reasoning does not go so far as to suggest that an objectively fairness-neutral term can never be struck down as giving rise to an unfair relationship. That would be too far, since the relationship-focus must mean that subjective analysis of the specific effect of the term on the specific debtor in specific circumstances will sometimes be necessary. But on Andrew Smith J's reasoning, a fairness-neutral term ought not generally to be subject to challenge under s.140A(1)(a). That is to say, where a term of a credit agreement is alleged to be unfair in itself, because of the obligations it actually imposes on a debtor, then it may be challenged under s.140A(1)(a); where however it is alleged not that the term is in itself unfair but that it is enforced unfairly, then the proper route for challenge is under s.140A(1)(b), in a complaint that the manner in which the creditor has sought to enforce its rights is unfair.

51. It ought not therefore to be enough for a debtor to say that a fairness-neutral term *may* be exercised unfairly and so should be subjected to a pre-emptive or injunctive form of order under s.140B(1)(b). If this approach is followed by the courts, the risk of expensive and sterile applications by debtors for "declarations of unfairness" is reduced, while use of the pre-emptive order under s.140B(1)(b) is comfortably confined to circumstances in which the creditor has in fact expressly or impliedly threatened to act in a particular way.

Powers

52. The powers of the court if it finds a relationship to be “unfair” are set out in s.140B(1):

> *“(1) An order under this section in connection with a credit agreement may do one of more of the following-*
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> *(a) require the creditor, or any associate or former associate of his, to repay (in whole or in part) any sum paid by the debtor or by a surety by virtue of the agreement or any related agreement (whether paid to the creditor, the associate or the former associate or to any other person);*
>
> *(b) require the creditor, or any associate or former associate of his, to do or not to do (or to cease doing) anything specified in the order in connection with the agreement or any related agreement;*
>
> *(c) reduce or discharge any sum payable by the debtor or by a surety by virtue of the agreement or any related agreement;*
>
> *(d) direct the return to a surety of any property provided by him for the purposes of a security;*
>
> *(e) otherwise set aside (in whole or in part) any duty imposed on the debtor or on a surety by virtue of the agreement or any related agreement;*
>
> *(f) alter the terms of the agreement or of any related agreement;*
>
> *(g) direct accounts to be taken, or (in Scotland) an accounting to be made, between any persons.”*

53. The ambit of these powers is breathtaking. Not only may a court refuse to enforce an agreement or require the return of monies paid, but it may also “alter the terms” of a credit or related agreement: a court is entitled to rewrite an agreement in such a manner as it sees fit in order to ensure that the agreement is not, in its view, “unfair”.

Vulnerability

54. The types of terms which one may expect to fall foul of the unfair relationships provisions will include the obvious culprits – excessive interest rates and default charges, for instance – but because unfairness, rather than mere excess, is the legislative touchstone, creditors may need to take a very subtle and case-specific approach to risk assessment when drafting their agreements. Where a term is per se alleged to be unfair, evidence of the thinking of the draftsman may need to be adduced, or at least of the risk assessment and analysis that leads for instance to the setting of interest rates.

55. Furthermore, although s.140A(1)(a) is on the face of it concerned principally with the substantive content of agreements, i.e. their meaning, it is very likely that it will be construed so as to cover form as well as content. Agreements should not only be full, clear and legible, but courts will be likely to find that prominence should be given to terms which operate disadvantageously to the debtor. It will not be enough merely to comply with the form and formality requirements of the Consumer Credit (Agreements) Regulations 1983; the “unfair relationships” provisions must be understood to be supplementary. Thus the old “red hand rule” may enjoy a come-back with respect to any onerous, unexpected or disadvantageous terms.

56. The conduct of the creditor and his agent will be relevant at each stage of the analysis. Evidently, misleading and/or coercing a person to enter into an agreement will certainly be matters to which courts will have regard, and the debtor’s circumstances are likely to be relevant in terms of whether the creditor took advantage of a debtor’s inexperience and/or the fact he was subject to financial pressure (as under the current extortionate bargain provisions). One

particular feature of the new legislation is that the related agreement provisions will bite where a creditor enters into successive credit agreements with the debtor, for example to obtain multiple fees for setting up each loan. Creditors would do well to ensure that where a dealership operates as their agents for certain purposes (e.g. under many hire-purchase transactions), they are able to monitor the manner in which the dealers interact with the hirers.

57. It is likely to be more in the enforcement of terms than in their draftsmanship that the new provisions are likely to come into their own. What was once good practice may become an effective legislative obligation: e.g. affording debtors a period of grace after a late payment before action is taken (save for any necessary statutory notices). As previously noted, a condition as to time when combined with a termination clause may be particularly vulnerable to a complaint that it has been enforced in such a way as to give rise to unfairness, because it is common in all forms of credit agreements for time to be made of the essence and for breach of any condition to give rise to a right to terminate, with the concomitant rolled-up claim by the creditor for all future payments. Although the contractual claim for payment may in many cases be attacked as a penalty (see below), s.140A enables a debtor to attack the enforcement of the termination provision itself. A successful attack of this type may result for instance in the court reviving an agreement which has been contractually terminated by the creditor.

58. The conduct of the creditor will remain relevant at all stages of the relationship, and importantly will include conduct extending after the time at which the credit agreement was entered into. The manner in which a creditor exercises or enforces any of his rights under the agreement expressly falls to be considered under s.140A(1)(b). It may be that a creditor who relies upon his strict contractual rights without adopting a reasonable approach to negotiation could be held to be acting unfairly.

59. Section 140A(1) makes clear that the court may look at the course of the relationship as a whole in determining whether a relationship is unfair. Thus it may be that certain matters which alone would be insufficient to persuade a court to intervene, may accumulate so as to persuade a court to do so.

60. Where there is concern that a past course of conduct or activity (rather than a term of the agreement) may if unremedied be deemed to be “unfair”, it is obviously open to the creditor to seek to neutralise the unfairness by appropriate mitigation in the present and for the future. However, Parliament has not legislated in such a way as to allow lenders easily to amend current agreements with debtors if they run the risk of being found “unfair” for any reason. An agreement may provide a contractual mechanism permitting the creditor to vary its terms. If the agreement is regulated, and a new agreement is made varying or supplementing it, then matters become somewhat complex and care will need to be exercised. A new “modifying agreement” will be created (under s.82), which will revoke the earlier agreement and will be treated as a regulated agreement if it meets the conditions for regulation.

LIQUIDATED DAMAGES AND PENALTY CLAUSES IN HIRE-PURCHASE AGREEMENTS

61. Both in the regulated and non-regulated credit spheres, arguments about penalty clauses are once again becoming commonplace in the courts. S.140A of the 1974 Act will not greatly affect the ever-present practical difficulties in distinguishing “liquidated damages” from “penalty” clauses: the court’s equitable jurisdiction to avoid penalties is not affected or expanded by the “unfair relationships” provisions. However, in cases of doubt involving credit agreements the new provisions may lead a court to give the debtor the benefit of the doubt.

62. The difficulties in definition and practice arise because:

    (a) Parties to a contract are free to agree in advance what the liability of a contract-breaker will be, so avoiding difficult questions of quantification or remoteness, and the ordinary rule that the courts apply is that contracts should be enforced according to their terms;[24] but

[24] Or, *pacta sunt servanda.*

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(b) The courts are reluctant to enforce a clause which provides for a payment by the contract-breaker of a sum which is manifestly greater than the innocent party's loss and will not do so where the purpose of the clause is to act as a deterrent against breach rather than to compensate the innocent party: *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79; *Lordsvale Finance Ltd v Bank of Zambia* [1996] QB 752.

Definitions

63. The former type of clause, which will be enforced by the court, is a liquidated damages clause; the latter is a penalty clause. The difference is easy to state, though not always obvious in practice. In the context of credit agreements, the common provision in hire-purchase contracts entitling the creditor to claim (after termination for breach) all future rentals that would have fallen due but for early termination is a ripe source of controversy, and has repeatedly been analysed by the courts as a penalty.

64. Indeed, the persuasive and very well-publicised county court decision of Judge Sennitt in *Volkswagen Financial Services (UK) Limited v Ramage* Lawtel 5/6/2007 is increasingly now relied upon to support the contention that wherever a hire-purchase (or hire) agreement provides for the rolling up of all future rentals, then the clause will be unenforceable as a penalty. As we will see, this is to over-state the true legal and equitable position by some margin. A closer understanding of the mechanism of clauses providing for payment termination sums may allow for more such clauses to survive judicial scrutiny. After all, as Diplock LJ said in *Robophones Facilities Ltd v Blank* [1966] 1 WLR 1428, the courts should not be astute to descry a penalty in every contractual provision purporting to fix the sum payable on breach.

65. A clause is not penal if it represents a genuine attempt to estimate in advance the loss that will flow from a given breach, since it is not stipulated *in terrorem* of the offending party: *Jobson v Johnson* [1989] 1 All ER 621. A "genuine" attempt means just that: the estimate must have been real and must be objectively and reasonably justifiable, but if it is both these things it is unlikely to be vulnerable to criticism. Thus, where a challenge is made to a clause, some evidence of the "liquidated damages" calculation may be necessary.

66. Where the estimate of loss provided for by the clause falls within a reasonable range of likely losses, it is not to be criticised as penal merely because as a matter of fact the actual loss sustained following breach differs from the estimate. The parties are not expected to be clairvoyants, and the innocent party cannot be criticised for not having precisely calculated the loss: see e.g. *Robophones Facilities Ltd v Blank* [1966] 1 WLR 1428. In the very protective case of *Alfred McAlpine Projects Limited v Tilebox Limited* [2005] EWHC 281 (TCC), Jackson J ruled that there should be a "substantial discrepancy" between the sum claimed and the loss likely to be suffered before the Court will decide that a pre-estimate is unreasonable.

67. The focus of the analysis is on the date at which the contract was made and the intentions / estimations at that date. There is no penalty clause if the sum claimed is <u>intended</u> to provide for a payment of a sum below the estimated loss: *Cellulose Acetate Silk Co Ltd v Widnes Foundry (1925) Ltd* [1933] AC 20. Although this does not mean as a matter of logic that wherever the stipulated sum is as a matter of fact lower than the actual loss the clause will not be held to be a penalty, in such a case the innocent party's claim will as a matter of practice be limited to the lower sum stipulated by the clause: *Diestal v Stephenson* [1906] 2 KB. In that sort of case, the innocent party may be well advised not to sue under the rolled-up damages clause at all, but to claim for his loss at common law.

68. The question of penalties does not arise where one party claims for a liquidated sum following consensual termination or following the election by the other party to terminate the agreement. In such a case, there is no question of loss flowing from a breach, because the other party has not breached the agreement. He has elected to terminate and therefore must be taken to have elected to pay the termination sum as the price of termination.[25]

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[25] But see s.99 and s.100 of the 1974 Act, which provide that where a debtor under a *regulated* hire-purchase agreement elects to terminate, his liability is limited to 50% of the total rental payments. The County Court case of *Rover Finance Ltd v Siddons* (unreported) drew on these provisions in circumstances in which the <u>creditor</u> had terminated the agreement: DJ Eaton held that

69. Neither is it penal to provide for the immediate payment of a debt that would, but for a contractual breach, be payable at a later date: *The Angelic Star* [1986] 1 Lloyd's Rep 122.

Rules of Construction

70. In the leading case of *Dunlop Pneumatic Tyre Co*, Lord Dunedin set out four rules of construction to assist in determining whether a clause is a penalty or a liquidated damages clause:

    (a) A clause is penal if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably have flown from the breach in question;
    (b) A clause is penal if the breach consists only in not paying a sum of money, and the sum stipulated is greater than the sum which should be paid;
    (c) There is a presumption that a clause is penal if it makes a single lump sum payable on the occurrence of one or more of a range of breaches of varying severity;
    (d) It is no obstacle to a sum being a genuine pre-estimate that the consequences of a breach are such that precise estimation is not possible. That, after all, is precisely the situation in which a liquidated damages clause is of particular comfort to the parties.

71. Turning back to the example of the rolled-up future rentals clause in a hire-purchase agreement, the typical such clause will generally make a single lump sum (future rentals, together with arrears) payable after termination by the creditor for a range of breaches committed by the hirer of a clause.

72. Accordingly, the presumption at point (c) above may often arise, albeit that it is no more than a presumption. Courts are often (though questionably) amenable to an argument that the validity of such a clause depends upon its normal operation, namely that termination for breach will be effected only where the breach is a serious one, and accordingly the presumption of penalty ought to be rebutted: a rolled-up future rentals clause was held by the Court of Appeal not to be penal in *Robophone Facilities v Blank* (above), notwithstanding that the clause was applicable whenever the agreement was terminated by the owner. Whether such a clause is a penalty will then depend more upon its specific terms than on a generalised presumption.

Clauses Providing for Payment of All Future Rentals on Termination

73. A rolled-up future rentals clause was indeed held to be a penalty by the House of Lords in *Bridge v Campbell Discount Co Ltd* [1962] AC 600 At p.625, Lord Radcliffe explained that:

    "The total hire-purchase price is called up [by the clause in question] to the extent of two-thirds, regardless of two considerations essential to any measurement of the owner's loss: the price includes a considerable interest element which the owner does not in the result forego, so far as the compensation is paid immediately, and the vehicle comes back into the owner's possession with a realisable value that, in many circumstances, may exceed the one-third balance of the price which the owner has not got in. In my opinion, a clause of this kind, when founded upon a consequence of a contractual breach, comes within the range of the court's jurisdiction to relieve against penalties...".

74. The two factors whose omissions were considered significant by Lord Radcliffe were, therefore, (i) the failure to forego the interest element on future rentals, and (ii) the failure to provide for the realisable value of any goods recovered early.

75. By the "considerable interest element", Lord Radcliffe was referring to the failure of the clause to provide any discount for acceleration of receipt. The future rentals under a hire-purchase, or indeed a hire, agreement are calculated so as to include a sum to represent the deferred

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a provision requiring the debtor to pay more than 50% of the total rentals where the agreement was terminated by the creditor was unenforceable as a penalty. Whether this is correct or not has yet to be considered in a citeable authority.

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payment to the owner / creditor of the capital price of the equipment. Early termination together with a payment made with respect to all future rentals would result in the owner / creditor recovering the interest element without suffering the deferral of payment. Therefore, many rolled-up future rentals clauses nowadays do provide a discount for acceleration.[26] Where an intellectually and arithmetically justifiable discount is provided for accelerated receipt, then no complaint can properly be made that the innocent party has not taken into account the fact that he will be receiving a single lump sum rather than payments over time.

76. Provision for realisable value is made where credit is given to the contract-breaker for any value obtained by the innocent party because of early termination: see e.g. *Robophone Facilities v Blank* (above). Thus, for instance, when a vehicle is recovered early under a hire-purchase agreement, the creditor should give credit for the value of the vehicle (usually as realised through sale), because the purchase of the vehicle by the debtor would be the consequence of payment by him of all the rentals (including the option fee). Where the agreement at issue is a pure hire, the position is similar but is frequently misunderstood.[27] The full realisable sale value of the equipment should not be credited, because the hirer never obtained and was never intended to obtain an interest as owner. However, early recovery will frequently be of benefit to the owner (e.g. because it will be able to hire out the equipment), and the owner ought to give credit for that benefit. Even if there is no re-hiring value, as if frequently the case, the owner will have benefitted from any increased present value of the equipment when compared to the residual value it would have had if the agreement had run to term. In order to avoid being classified as penalties, a rolled-up future rentals clause should take into account such realisable value.

77. If a rolled-up future rentals clause is expressed so as to give credit for the interest element and realisable value of any recovered equipment or benefits to the innocent party, then the risk of its being struck down as a penalty should be low. It is worth noting in any event that a properly drawn unregulated contract will provide in any event that breach of an obligation by the hirer is repudiatory, which will entitle the creditor / owner to terminate the agreement and to claim damages at common law. Such damages will in many cases be very similar if not identical to the sum calculable by reference to the future rentals less a discount for accelerated receipt and credit for realisable value or benefits received / expenditure avoided. A provision defining a term of the contract as a condition is not penal (*Lombard North Central plc v Butterworth* [1987] 1 QB 527) and as a result in a great number of cases the creditor will be entitled to claim the same or a similar sum of money as damages at common law on the expectation measure. The benefit to relying on the liquidated damages clause, of course, is that it will give rise to a debt which may properly found a winding-up or bankruptcy petition.

Effect of Finding of Penalty

78. Even where such a clause is properly held to be penal, however, that is not the end of the story. The court's equitable jurisdiction is to refuse to enforce the penal part of the sum claimed, and to give judgment for the actual damage suffered at common law. In *Interoffice Telephones Ltd v Robert Freeman Co Ltd* [1957] 3 All ER 479, Jenkins LJ approved the approach of the parties in the court below, who on conceding that the clause in issue was penal *"proceeded on the footing that the provision of cl 8 expressed to be operative in the event of default should be disregarded, and that the owners should be entitled to recover whatever damages, on the proper principles as to the assessment of damages, they could claim to have suffered through the hirer's default"* (at 481). As has been noted, this will very often be the same sort of sum

[26] Judicial practice is inconsistent, however, when it comes to whether a discount should be applied from the date of termination even if payment is not made until much later. It is arguable that, given that a discount is made to reflect acceleration of payments, no discount should be applied until payment is made: see in the regulated sphere *Forward Trust Ltd v Whymark* [1990] 1 QB 670. However, if as is usually the case (i) interest is charged on the unpaid termination sum and (ii) the acceleration deduction is in part to ensure that the interest element of the rental charges is not claimed where no deferral is suffered, would the creditor not recover interest twice over if it were entitled to refuse credit for acceleration until payment but nonetheless claims statutory or contractual interest on the full termination sum until payment?

[27] Even, with respect, in the Technology and Construction Court. In *Lobster Group Ltd v Heidelberg Graphic Equipment Ltd* [2009] EWHC 1919 (TCC), Ramsey J did not make a deduction from the sum payable by the hirer of a graphic press, where the press had been recovered early following termination for breach, on the basis that the hirer never had an interest as owner in the equipment. That much is true, but the owner nonetheless recovered the press early, and to the extent that early recovery was of value to it, some credit should have been given. At the very least, whether there was any realisable value from the early recovery required consideration.

(where there has been the breach of a condition); only where the contract-breaker has breached a warranty will the innocent party find itself particularly disappointed. Where the breach in question was the late payment of an instalment and there is no provision making time of payment of the essence, then in the worst case scenario the innocent party may be entitled only to interest on the late sum.

The European Dimension

79. The final topic to cover is that the Consumer Credit landscape is about to change all over again. Having just completed the implementation of the 2006 Act, the consumer credit industry now has a short time in which to prepare for the implementation of the European Credit Directive, (the "**ECD**") which must be transposed into English law by June 2010.

80. The ECD is a maximum harmonisation directive and so there is limited scope for the English consumer credit regime to deviate from the provisions of the directive. The main issue is that the CCA in its current form is wider and much more prescriptive than the requirements of the ECD. Consequently, the task of harmonisation is a difficult one and the key task for the Government is to resolve how to treat agreements which currently fall within the CCA, but outside the provisions of the ECD.

81. The problem for the consumer credit industry is that the provisions of the ECD potentially require far reaching changes which affect everything from advertising; the form and content of agreements; the supply of pre and post contract information; the calculation of the APR and other matters arising during the lifetime of an agreement. The tight timescale for implementation, exacerbated by the likely pressures on parliamentary time next year are causing widespread concern. A notable feature of the ECD is that it places a positive obligation on lenders to assess the credit worthiness of borrowers before the agreement is made.

82. A further example of the fundamental problems is the fact that the ECD regulates consumer credit agreements only where the amount of credit is Euros 75,000 (roughly £60,000). As seen previously, there is no financial upper threshold under the CCA. Equally, the ECD does not regulate lending for business purposes and the definition of "consumer" – those persons who enjoy the protections of the ECD – excludes unincorporated associations and partnerships.

83. The Government consulted on the implementation and scope of the ECD over the summer and published draft regulations which are still subject to change. It is likely to be the end of this year before industry sees the final form regulations. Listing all the potential problems and issues would require a complete seminar in itself, but the consultation and draft regulations are available at: www.berr.gov.uk/whatwedo/consumers/consumer-finance

84. In the meantime, the consumer credit industry holds its breath.

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