
# Penalty Clauses and Enforcement issues

## *Flynn & Anor v Breccia* [2018] IECA 273; *Sheehan v Breccia & Ors* [2018] IECA 286

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In the recent linked decisions of *Sheehan v Breccia* and *Flynn and Benray v Breccia* the Court of Appeal upheld the High Court's finding that a surcharge interest provision in a loan agreement was a penalty clause. In doing so it followed the established caselaw on what constitutes a penalty clause in this jurisdiction.

## Penalty Clauses

If a clause in a contract provides for the payment of a sum of money in the case of a breach of that contract, the courts may deem that clause to be a penalty clause. In Ireland the test is whether the amount payable is a genuine pre-estimate of the probable loss of the innocent party caused by the breach of the contract. If it is not, the clause is a penalty and is unenforceable.

In 2015 the Supreme Court in the UK departed from the traditional test in the case of *Cavendish Square Holding BV v Talal El Makdessi*. The court in that instance found that the test was whether the clause amounts to an additional secondary obligation which imposes a detriment on the party who is in

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breach, which is out of all proportion to any legitimate interest of the innocent party.

## Factual Summary

The plaintiffs were shareholders in the Blackrock Clinic. They financed the purchase of their shares through loans from Anglo Irish Bank ("**Anglo**"). The plaintiffs gave security for the loans in the form of mortgages over their shares. When Anglo entered into liquidation, the plaintiffs' loans were put up for sale by the special liquidators of Anglo's successor, Irish Bank Resolution Corporation ("**IBRC**"). Breccia, another shareholder in the Blackrock Clinic, purchased the plaintiffs' loans (outbidding the plaintiffs who were attempting to buy back the loans). Breccia then demanded repayment. During the course of litigation between the parties before the High Court, a question arose as to whether Breccia was entitled to include default surcharge interest and costs of enforcement in the redemption figure.

## Court of Appeal

The principal issues to be determined by the Court of Appeal in *Sheehan* and *Flynn* were as follows:

i. **Did the application of default surcharge interest amount to a penalty clause?**

   The court found that it did amount to a penalty as the surcharge rate of 4% over the facility interest rate was not a genuine estimate of Anglo's loss or damage upon a default by the plaintiffs in the payment of any monies on a due date.

ii. **If the surcharge interest clause was not a penalty, was Breccia estopped from claiming surcharge interest?**

   The court found that Anglo and its successors were estopped from claiming surcharge interest. This was because there was no reference to any surcharge interest in bank statements or correspondence with the plaintiffs, and this amounted to a representation which was relied on by the plaintiffs when they incurred costs in attempting to buy back their loans.

iii. **What enforcement costs could be included in the redemption figure to be paid to Breccia?**

   The court considered the interaction between a contractual provision which allows a secured lender to recover enforcement costs and the jurisdiction of the courts to award costs. The court distinguished between costs incurred by a lender outside of litigation and costs incurred in the course of litigation. Contractual provisions in

relation to the former were found to be effective. The court held that contractual provisions in relation to the latter raised public policy issues as the courts have absolute discretion in determining who pays costs. The court found that such provisions could not fetter its powers, instead finding that the appropriate practice is for the party seeking to enforce the clause to bring it to the court's attention when the issue of costs is being determined, at which point the court could take it into account.

## Comment

The Court of Appeal's finding that a surcharge interest clause is a penalty will be a cause of concern to lending institutions. For the moment it is clear that any clauses which are not a genuine pre-estimate of the losses which would occur on default will be found to be a penalty clause in this jurisdiction.

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