

BAD PENNIES

The common law right to interest clarified

This paper examines the ability to claim interest, particularly as it applies to adjudications under the Construction Contracts Act 2002

Legal rules which are not soundly based resemble proverbial bad pennies: they turn up again and again. The unsound rule returning once more for consideration by your Lordships' House concerns the negative attitude of English law to awards of compound interest on claims for debts paid late.

Lord Nicholls of Birkenhead¹

1. Introduction

All too frequently, adjudicators are presented with claims which include a request for *interest on the amount determined at the rate of 8.4% under the Judicature Act*, or similar. This gives rise to the vexed question of whether or not there is a common law right to claim interest, and if so, what interest rate is to be used, and how is it to be applied.

It has been a long standing rule at English law that in the absence of any agreement, the court has no power to award interest as general damages.² In other words, as compensation for the late payment of a debt or damages.³ This has led to the mantra that *there is no freestanding right for adjudicator to award interest* gaining considerable authority, by repetition if nothing more.

However, this is not the entire picture. Interest is recoverable if there is agreement between the parties (typically in leases, construction contracts and other commercial arrangements, there is a late payment interest provision), statutes do provide for interest in some circumstances, and it has been accepted for some time that interest can be recovered if it was in the contemplation of the parties that there would be an interest cost in the event of delayed payment.⁴

The recent House of Lords opinion in *Sempra Metals v Commissioner of Inland Revenue*⁵ reopens the whole issue, and extends the exceptions to the general rule to such an extent that it can fairly be said that the prohibition against awarding interest is of limited application. That approach was considered and adopted in

¹ *Sempra Metals Limited v HM Commissioner of Inland Revenue* [2007] UKHL 34 at para [51]

² *London, Chatham & Dover Rly Co v South Eastern Rly Co* [1893] AC 429

³ This approach is almost certainly a reflection of lingering religious dogma. Pope Sixtus V, in the late 6th century, is said to have described charging interest as “*detestable to God and man, damned by the sacred canons and contrary to Christian charity*”. Shakespeare reflected a similar view in his depiction of Shylock in the *Merchant of Venice* some years later. The Qu’ran also enjoins believers to *Fear Allah!* and give up demands for interest (2:275-6).

⁴ Applying the second limb in *Hadley v Baxendale* (1854) 9 Ex. 341

⁵ See fn 1 above.

New Zealand by the Court of Appeal in the case of *Clarkson & Peninsula Metal Supplies v Whangamata Metal Supplies & Rea*.⁶

This article considers how that approach can be applied to adjudications under the Construction Contracts Act 2002.

2. Contractual rights of interest

It must be acknowledged at the outset that, if a contract provides for interest on an amount due, then provided interest is claimed, it may be awarded at the contract rate.⁷

While late payment interest is a reasonably common provision in commercial contracts, such provisions tend to apply only to the late payment of progress claims, rather than to any other amount found payable under the contract, whether as damages or a payment which either party is entitled to receive under the contract (but not included in a payment claim).⁸ In most cases, where the claim is based on the contractor relying on a valid *payment claim* under section 20 and a failure by the owner to provide a *payment schedule* in terms of section 21, the contractual provision for interest will be sufficient.

Where the claim is for money otherwise due under the contract, the position is not so straightforward. While a claim for the cost of rectification of defects, liquidated damages, damages generally under a contract may be covered in a *payment schedule*, it does not need to be; sometimes it cannot be as there are no further *payment schedules* to be issued. The owner is not reliant on a contractor raising a *payment claim* to recover these sums. Yet, unless the contractual provisions extend the right to claim interest to all sums due, which would be unusual, there is no authority in contract to simply apply the default contract rate to such sums.

Without a common law right to interest, claimants are only entitled to interest strictly in terms of the relevant clause. This will typically relate only to the late payment of a *scheduled amount*.

3. Judicature Act 1908, Arbitration Act 1996 & Construction Contracts Act 2002

The position in the High Court, Court of Appeal and Supreme Court is removed from any doubt by section 87 of the Judicature Act, which provides for interest to be awarded at the *prescribed rate* in any proceedings for the recovery of any debt or damages.⁹ The prescribed rate was set at 8.4% as from 1 July 2008.¹⁰

This approach may have the advantage of familiarity for most litigators and arbitrators, but it must be confined to its statutory application. The Judicature Act does not apply to adjudications, or for that matter to arbitration. There is no justification for simply extending the Judicature Act rate whether as a matter of

⁶ [2007] NZCA 590, O'Regan, Arnold and Ellen France JJ

⁷ See *Carillion Construction Ltd v Devonport Royal Dockyard Ltd* [2003] B.L.R. 79

⁸ See clause 12.7.3 of NZS3910:2003

⁹ The District Courts have a similar power under section 62B of the District Courts Act 1947.

¹⁰ See clause 4 Judicature (Prescribed Rate of Interest) Order 2008 (SR 2008/145) and clause 4 of the District Courts (Prescribed Rate of Interest) Order 2008 (SR 2008/144).

practice, a misguided sense of business efficacy or out of sheer laziness. It simply doesn't apply.

For arbitrations, section 12 of the Arbitration Act 1996 deems a provision in the agreement to arbitrate that the tribunal may award interest on an amount awarded up to the date of the award.¹¹ Consistent with the concept of *party autonomy* central to arbitration, the parties are free to agree otherwise.

There are no equivalent provisions in the Construction Contracts Act. On that basis, without an agreement to extend the jurisdiction of the adjudicator to include provision for interest in the determination,¹² the prohibition against a *free standing right* to award interest would seem to be justified.

The Judicature Act and the Arbitration Act go to some lengths to provide for interest, while the Construction Contracts Act does not. This does seem to give rise to a presumption, albeit a weak one, that interest cannot be awarded by adjudicators. To my mind, the converse is also true.

The absence of a statutory power to award interest seems to me to leave the common law rules in place. If the legislature intended to displace the common law rules, it could also be said that it would have done so explicitly. Adjudicators have jurisdiction to determine disputes under construction contracts, which includes the determination of liability for amounts of money due and the rights and obligations of the parties under such contracts.¹³

The determination of any such dispute necessarily extends to the application of all relevant legislation and the common law; including as they apply to the right to recover damages.¹⁴ While a distinction can be drawn between a claim for payment of a debt under a contract, and a claim for damages,¹⁵ the Construction Contracts Act does not appear to adopt that distinction.

The distinction also needs to be made between *interest on damages* (to which the District Courts Act 1947 would apply on the entry of an adjudicator's determination as judgment under section 73 of the Construction Contract Act) and *interest as damages*, which is determined as a separate head of damage by the adjudicator in the determination.

¹¹ Subject to what may be in the agreement to arbitrate, the amount awarded carries interest from the date of award at the same rate as a judgment debt (see rule 31, Chapter 6, Schedule 1 of the Arbitration Act 1996).

¹² It is worth noting that the extension of jurisdiction can, it seems, be implied. In *Carillion Construction v Devonport Royal Dockyard* referred to in fn 7 above, a common law request for interest was included in the claim. The fact that the respondent failed to challenge the jurisdiction of the adjudicator to award interest was taken to be a waiver.

¹³ See section 48 of the Construction Contracts Act.

¹⁴ The contrary position has been argued that, while liquidated damages may be the subject of an award, adjudicators do not have the jurisdiction to award general damages. On the basis that liquidated damages are simply an enforceable pre-estimate of one aspect of general damages, this argument is not compelling. Damages for breach of contract are generally to put the parties in the position they would have been under the contract, but for the breach – see Cooke J in *Stirling v Poulgrain* [1980] 2 NZLR 402 at 419 (for a recent re-expression of the law in the UK see *Golden Strait Corp v Nippon Yusen Kubishika Kaisha* [2007] UKHL 12). On that basis, the entitlement to damages can only arise out of the contract, and are properly either moneys due under the contract or relate to the parties rights and obligations under it.

¹⁵ See *Chitty on Contracts* 13th Edition at para 21-040.

4. Special Damage

The general rule against the recovery of interest as a part of a damages claim under the *London Chatham* case was modified in 1952,¹⁶ and again by the English Court of Appeal in the 1981 case of *Wadsworth v Lydall*.¹⁷ In that case, the Court of Appeal determined that, provided the test for remoteness of damage was satisfied, damages may be awarded for interest paid and other expenses incurred (eg, securing alternative finance).

The test for *remoteness of damage* is often referred to as the two limb test in *Hadley v Baxendale*.¹⁸ The test as originally applied arose out of the following statement by Alderson B:

*Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, ie according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.*¹⁹

What is said to be the *first limb* of the test relates to what could be imputed to the parties – ie, what the parties could reasonably be considered to have known from the ordinary course of business. The *second limb* relates to what they actually knew.

In *Wadsworth v Lydall*, Brightman LJ commented:

*If a plaintiff pleads and can prove that he has suffered special damage as a result of the defendant's failure to perform his obligation under a contract, and such damage is not too remote on the principle of Hadley v Baxendale, I can see no logical reason why such special damage should be irrecoverable merely because the obligation on which the defendant defaulted was an obligation to pay money and not some other type of obligation.*²⁰

This approach was followed in New Zealand in the 1994 Court of Appeal decision of *Lion Nathan & Ors v CC Bottlers & Ors*.²¹

Regrettably, the reference to *special damage* was picked up by the House of Lords in the *President of India* case, and a distinction was drawn between *general damage* under the *first limb* of *Hadley v Baxendale*, and *special damage* under the

¹⁶ Denning LJ in *Trans Trust SPRL v Danubian Trading Co Ltd* [1952] 2 QB 297.

¹⁷ [1981] 1 W.L.R. 598. This case and the *Trans Trust* case were considered and approved by the House of Lords in *President of India v La Pintada Compania Navegacion* [1985] A.C. 104 at 125-127. In Australia the view was that this approach subverted the rule in *Hadley v Baxendale* – see Mason CJ in *Hungerfords v Walker* (1989) 171 CLR 125 at 142.

¹⁸ *Hadley v Baxendale* (1854) 9 Ex. 341

¹⁹ At 354: 151.

²⁰ At page 603

²¹ (1995) 5 NZBLC 103,681 (CA)

second. This rather unhelpful distinction led to some strained reasoning, and a dead end in the assessment of remoteness of damage.²²

5. **Sempra Metals**

In the case of *Sempra Metals v Commissioner of Inland Revenue*, the House of Lords took the opportunity to revisit the whole issue of interest as damages. Interestingly, the question of interest was not directly at issue; the case turned largely on the question of unjust enrichment. However, the opportunity to correct what they viewed as two hundred years of bad law was too good to miss.

Their Lordships spared little time in limiting the restrictive rule in the *London Chatham* case. Lord Nicholls was most eloquent on the issue, and enjoyed the support of his colleagues:

*The common law should sanction injustice no longer. The House should recognise the remnant of the restrictive common law exception for what it is: the unprincipled remnant of an unprincipled rule. The House should erase the remains of this blot on English common law jurisprudence.*²³

In relation to the application of *Hadley v Baxendale* to interest claims, Lord Nicholls suggested that the analysis was relatively simple:

*Those who default on a contractual obligation to pay money are not possessed of some special immunity in respect of losses caused thereby. To be recoverable losses suffered by a claimant must satisfy the usual remoteness tests. The losses must be reasonably foreseeable at the time of the contract as liable to result from the breach. But, subject to satisfying the usual damages criteria, in principle these losses are recoverable as damages for breach of contract. This is so even if the losses consist of a liability to pay borrowing costs incurred as result of the late payment, as happened in *Wadsworth v Lydall* ... the House should now hold that, in principle, it is always open to a claimant to plead and prove his actual interest losses caused by late payment of a debt. These losses will be recoverable, subject to the principles governing all claims for damages for breach of contract, such as remoteness, failure to mitigate and so forth.*²⁴

Applying this approach, the artificial distinction drawn between the first and second limbs of *Hadley v Baxendale* effectively falls away. In their Lordship's view, the first and second limbs are simply expressions of the one test of remoteness.

In relation to the issue of compound interest, as against simple interest, Lord Nicholls was relatively dismissive:

We live in a world where interest payments for the use of money are calculated on a compound basis. Money is not available commercially on simple interest terms. This is the daily experience of everyone, whether borrowing money on overdrafts or credit cards or mortgages or shopping around for the best rates when depositing savings with banks or building societies. If the law is to achieve

²² As observed by Mason CJ in *Hungerfords v Walker*, see fn 17 above.

²³ Lord Nicholls at para 92.

²⁴ Lord Nicholls at paras 93 & 94.

*a fair and just outcome when assessing financial loss, it must recognise and give effect to this reality.*²⁵

The issue which also arises out of the speech is that it is *actual interest losses* which are recoverable, rather than the narrower and the easier to prove concept of borrowing costs. Lord Nicholls clarified this issue, by observing that the loss may be the cost of borrowing money, and similarly it may be the loss of an opportunity to invest the money.²⁶

The only remnant of the *London Chatham* case which his Lordship would concede continues to apply was that unparticularised and unproven claims for damages would not be recoverable:

*The common law does not assume that delay in payment of a debt will of itself cause damage. Loss must be proved.*²⁷

This seems a small concession, and of limited application. Granted, claims should not simply apply interest to the total claimed. But with overdraft and interest rates being relatively transparent, it should be no difficult matter for a claimant to convert an *assumption* of loss into a proven figure which would be recoverable.

The approach of the House of Lords in *Sempra Metals*, and in particular the speech of Lord Nicholls, was considered and followed by the New Zealand Court of Appeal in *Clarkson & Peninsula Metal Supplies v Whangamata Metal Supplies & Rea*.²⁸ The Court of Appeal observed that it was “*time for the same clarity and certainty to be brought to New Zealand law*”.²⁹ Having summarised the local case law, and preferring the criticism of the hard line between the two “limbs” approach, O’Regan J observed:

*In principle, therefore, we would be prepared to allow the recovery of interest as damages under either limb of Hadley v Baxendale.*³⁰

The Court of Appeal then adopted the House of Lords approach to particularised and proven loss.

6. Application of Interest

In practical terms, this does not mean that interest can simply be applied to the amount determined as due. Interest will only run from the time particular sums became due. Each must be particularised and proven.

Goods & Services Tax

Most claims will include provision for GST. As a matter of practice, many adjudicators will simply exclude the GST from any interest calculation. While it may be that most contractors will not pay GST until a claim has been paid, it must be

²⁵ See Lord Nicholls at para 52.

²⁶ See Lord Nicholls at para 95.

²⁷ At para 96.

²⁸ [2007] NZCA 590.

²⁹ At para 32.

³⁰ At para 36.

remembered that the time of supply under section 9 of the Goods and Services Tax Act 1985 is the *earlier* of the time an invoice is issued and the time of payment.³¹

In strict application, contractors will become liable to pay GST on the total amount included in a GST invoice, regardless of when it is paid. If the sum is not paid, the contractor may write off the debt and claim a credit in subsequent GST returns. But as a general rule, the fact that a scheduled amount has not been paid does not relieve the contractor of the obligation to account for the GST which is due on that sum.

If a claimant can prove that GST has been paid (through the simple expedient of establishing that the GST has been included in a GST return), then interest on the GST inclusive amount due may be included in the determination.

Prospective losses

Similarly, a claim may include a *prospective loss*, ie a loss which is reasonably anticipated as likely to result from the breach. This most commonly arises where a loss is sustained by one company, and a related company is entitled to make a claim against that company, but has chosen not to do so. In recovering its losses from the party in breach, the company may include its liability to the third party.³²

It is hard to envisage a situation in which such losses would carry interest, as they would be difficult to prove.

7. Conclusion

The starting point will always be whether or not the contract provides for the payment of interest, and whether or not the entitlement to interest extends to all moneys determined to be due in an adjudication. It may well be that unpaid *scheduled amounts* carry interest at the contract rate, and other sums will require another rate.

Where there is no interest provision, or it does not apply to the payments in question, then there is a common law right to interest. It is fair to say that the *longstanding principle* that debts do not carry interest has been so restricted as to have effectively been laid to rest.

Any claim for interest as damages must satisfy the general principle of remoteness. But provided it is included in the pleadings and proven, it will be recoverable as damages. Whether or not this comprises a *freestanding right* for adjudicators to award interest is probably nothing more than semantics.

John Walton
12 March 2009

³¹ There are circumstances where a tax payer may move onto a receipts basis (ie, the time of supply is the time of receipt of payment), this is exceptional and unlikely to apply to most significant construction companies.

³² See *Chitty on Contracts*, 13th Edition at para 26-013.