Scottish Law Commission
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ISSUED ON BEHALF OF THE SCOTTISH LAW COMMISSION

NOT FOR PUBLICATION OR BROADCAST

BEFORE 0001 HOURS 17 January 2005

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Discussion Paper on Interest on Debt and Damages

The law of interest on debt and damages is examined in a discussion paper published today by the Scottish Law Commission.

In the paper ("Discussion Paper on Interest on Debt and Damages" (No 127)) the Commission analyses the development of the law on interest and makes proposals for reform. The current law has been examined to determine the extent to which it satisfies three basic principles:

1. Interest should run on different types of claim for money during the same period and at the same rate regardless of whether the claim is for payment of a contractual debt, a non-contractual debt or damages.

2. The primary goal of an award of interest should be the realistic compensation, in commercial terms, of the creditor for loss of the use of money or property. Interest should not as a general rule be payable at a punitive rate.

3. An award of interest should compensate the creditor for loss of the use of money or property throughout the period during which that loss has subsisted.

Applying these principles, the Commission seeks public comment on a range of proposals which, if accepted, would see the introduction of a statutory right to claim interest from the date when a claimant loses the use of money or property.

Background

In November 2003 the Scottish Law Commission received a reference under the Law Commissions Act 1965 from the Minister for Justice, Cathy Jamieson MSP to examine this area of the law with a view to recommending reform.

The Discussion Paper is issued for public consultation as the first part of the Commission's work on the reference. The Commission will consider comments on the Paper submitted by 29 April 2005 before reaching conclusions to be included in a final report.

Most claims for interest arise either from a claim for payment under a contract or out of a claim for damages for breach of a contractual or other obligation. The Discussion Paper is concerned with those types of claim. The Paper deals in particular with entitlement to interest on contractual debt where the contract contains no provision creating or excluding an entitlement to interest in the event of delayed payment. Other circumstances in which interest may be due are also considered: for example, where a person holds funds on behalf of another and delays in making them over when payment has fallen due.

The Paper does not deal with contractual terms which impose exorbitant interest charges. Legislation is already in force which regulates the charging of interest in consumer contracts (eg the Consumer Credit Act 1974) and it was not within the scope of the project to review the adequacy of that protection.

Problems with the Present Law

The law governing entitlement to interest has evolved over the centuries without any general underlying principle. Although the charging of interest was once restricted under laws prohibiting usury, it is now generally accepted that that an award of interest is the best way of compensating a person for the loss of use of money. However, for a number of reasons the interest awarded may not necessarily be an accurate measure of a claimant's loss.

In the Paper, the Commission argues that the current law on interest lacks principle and consistency: interest may or may not run on a claim for payment depending upon whether it is categorised as a debt or as a claim for damages.

The Commission identified the following areas of concern with the present law:

Inconsistent treatment of debt and damages: there is a significant difference between the treatment of interest on contractual debts and interest on damages. Injured parties suing for damages may, in terms of the Interest on Damages (Scotland) Act 1958 (as amended in 1971), claim interest from the date when the right of action arose (eg the date of an accident). However, a party pursuing a contractual debt may claim interest only from the date of judicial demand (ie the date the party raises a court action). Whether a claim arises from damages or from debt, the pursuer has lost the use of his or her money from a specific date and it seems unfair for legal entitlement to interest to be less generous in one type of claim than in another.

The concept of "wrongful withholding": the treatment of interest on contractual debts flows from the development by the courts in the 19th century of the concept of "wrongful withholding". Interest would not be payable on a debt unless payment had been "wrongfully withheld" and the rule developed that in the case of contractual debt money was not wrongfully withheld until court proceedings were commenced. This means that where the debtor delays payment the creditor will not be compensated for not having the use of his money prior to starting proceedings in court.

Interest on damages: when the Interest on Damages (Scotland) Act 1958 was amended in 1971, the wording of the statute was subject to judicial criticism. Although the purpose of the amended Act was reasonably clear, it has required some judicial interpretation in its practical application. There remains some uncertainty as to the starting date for interest to run on particular heads of claim: eg when does interest run on out-of-pocket expenses which were quantifiable at a date earlier than the date when the claimant actually incurred them? The existing legislation could be replaced with new provisions which would ensure uniform treatment of interest on debts and on damages.

Rate of interest: there is at present no statutory mechanism which would apply a rate of interest similar to that which is available commercially. The "judicial rate" (currently set at

8%) does not fluctuate automatically in line with changes in the Bank of England base rate and often may not reflect the real cost of money to the creditor or the debtor. The result is often an award of interest which is not truly compensatory because the debtor may be paying interest at a rate higher than the creditor could have obtained in the market.

Summary of Proposals for Reform

The Paper proposes the creation of a comprehensive system of entitlement to interest which would not differ depending on the legal classification of the claim.

With regard to contractual debt, the Commission proposes the introduction of a statutory entitlement to interest which would run from the date when payment is due. At present, interest is available under the Late Payment of Commercial Debts (Interest) Act 1998 on certain types of contract where both parties are acting in the course of a business. The Commission's proposals would apply to a wider range of contracts, whether or not the parties were in business. In relation to contracts for the supply of goods and services, interest would run from the date of payment agreed by the parties or, if there is no such agreement, 30 days after the later of the day on which the supplier's obligation is performed and the day on which the purchaser has notice of the amount claimed by the supplier. It is proposed that the general rule should also apply to sales and leases of land and to earnings from employment.

The proposed statutory entitlement would not apply where parties have made express provision for interest in their contract. Nor would it apply to circumstances in which provision for payment of interest is made by another statutory provision: eg interest on taxes and duties, which is already governed by legislation, would not be affected by the proposals.

With regard to interest on damages, a change is suggested to the existing statutory provisions which determine the commencement date for the running of interest. At present the court has a *discretion* to award interest for any part of the period since the date when the right of action arose and a *duty* to award interest on damages or solatium for personal injury unless satisfied that there are reasons special to the case why no interest should be given. It is proposed that this commencement date would be replaced by an entitlement to interest on each head of loss from the date when the loss in question was sustained. The Commission invites comment on the extent, if any, to which judicial discretion to award interest from a later date or on a lesser sum should be retained.

The Commission also invites comment on a proposal that there should be a prescribed rate of interest which would fluctuate according to the Bank of England base rate. The rate prescribed by statute would be a specified percentage, such as 1% or 1.5%, above the official dealing rate of the Bank of England. The resulting rate of interest would be comparable to the rate which a prudent individual might obtain for a secured loan, or the average company might pay on its borrowing.

Compound Interest Calculator

The Commission seeks views on a proposal that, if legislation specifies a rate of interest, it should allow for that interest to be compounded at specified intervals. At present, when a court awards interest on a claim, whether for debt or damages, it is calculated, with only a few exceptions, as simple interest. Where interest is charged until payment the interest due is calculated once: at the date of payment. However, normal commercial practice on, for example, a bank account or a consumer debt, is to compound interest at regular intervals, usually monthly.

The introduction of compound interest would be combined with the use of a rate of interest which was closer to the rates available in the market. The entitlement to interest would not necessarily be greater than at present when simple interest is applied at the judicial rate, but it would be a more accurate reflection of the true cost of money over the period of the claim.

A general entitlement to compound interest would have little impact on consumer debt, where the effect of compounding in combination with high rates of interest is sometimes a cause for concern. Debts such as those on credit cards are usually subject to a written contract which specifies that interest will be compounded every month.

A common objection to compound interest is that it is more complex and its effect less predictable than simple interest. The Commission proposes that a computer program designed to ease the calculation of compound interest be made available to the public free of charge on a website. In support of this proposal, a program is now accessible on the Commission's own website:

www.scotlawcom.gov.uk/html/calculator.htm

The calculator is easy to use: the user types in the principal sum (ie the sum awarded or the principal debt), then the start and end dates for the calculation and clicks on a button marked "compute". The final sum is calculated automatically according to a set formula. The interest rate applied is the Bank of England base rate plus 1%, as it varies over monthly intervals.

Research

The Discussion Paper also contains the results of research which was carried out at the Court of Session and at Aberdeen Sheriff Court last year. Members of the project team examined court papers for more than six hundred cases to ascertain what kind of interest was being claimed in practice.

NOTES TO EDITORS

1. The Scottish Law Commission was set up in 1965 to promote the reform of the law of Scotland. The Chairman is Lord Eassie, a senior Scottish judge. The other Commissioners are Professor Gerard Maher QC, Professor Kenneth G C Reid, Professor Joseph M Thomson and Mr Colin J Tyre QC.

2. Further information can be obtained by contacting Alastair Clyde, Scottish Law Commission, 140 Causewayside, Edinburgh EH9 1PR (Tel 0131 668 2131, Fax: 0131 662 4900, email: info@scotlawcom.gov.uk.).

3. The paper may also be viewed on our website at *www.scotlawcom.gov.uk* or purchased from TSO Scotland Bookshop.