When compensation is limited: the specific case of no-show clauses from an English and European perspective.

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1. Introduction

Penalty clauses are parts of our daily lives, but we are unaware of their existence until a breach of contract occurs. Penalty clauses are not limited solely to the payment of money, in certain circumstances, they can also exclude liability and compensation, as is exemplified by the no-show clauses (hereinafter referred to as "NSCs") present on every flight ticket. This clause, embodied in Articles 3.3.1 and 3.3.2 of the International Air Transport Association (hereinafter referred to as "IATA") General Conditions of Carriage Recommended Practice 1724, allows airlines to cancel without refunding a reservation in two situations: a) when the passenger missed the first leg of a multi-leg itinerary or b) when the passenger missed the outbound flight of a round-trip itinerary. At first sight, it seems that penalty clauses are detrimental to consumers as they limit the liability of airlines and waive passengers' right of compensation and should, therefore, be abolished. However, as will be argued, NSCs play an important role in protecting airlines and should be preserved in situation a), but abolished in situation b).

NSCs are a difficult subject that only a few legislators and judges have addressed.[1] Indeed, although NSCs obviously limit the carrier liability for no good reason, as the ticket was paid and passengers should be able to use it as they wish, NSCs also protect airlines. NSCs leave a great liberty to carriers while restricting the freedom of passengers by, in a sense, obliging passengers to use their tickets or lose their money without any compensation. By the simple fact that the passenger did not board on the first flight and did not call the airline company, the contract is automatically broken, and all subsequent tickets are cancelled.

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[1] For instance, in Brazil, such clauses have already been successfully challenged in court: TJ-DF – Apelaçao Civel no Juizado Especial ACJ 20050110145947 DF (TJ-DF), 01/12/2005.
Since 2015, airlines are prohibited to cancel the return flight even though the passenger did not use the outbound part of the ticket: TJ-PR – Processo Civel e do Trabalho, Recursos RI 00349003920148160182 0 PR 0034900-39.2014.8.16.0182/0 (Acórdão) (TJ-PR), 25/06/2015; TJ-RJ – Recurso Inominado RI 00091142820148190208 RJ 0009114-28.2014.8.19.0208 (TJ-RJ), 14/10/2015
The UN Convention on Contracts for the International Sale of Goods ("CISG") does not regulate penalty clauses. In fact, the drafters agreed to leave these clauses out of the convention, due to wide divergences in the different legal system.

NSCs seem to qualify as penalty clauses as understood in English law and under EU law. Despite the fact that some EU instruments have been enacted to regulate unfair contract terms, the UK has taken a somewhat different approach. Indeed, English courts rely on the English doctrine on penalties, which focuses on the freedom of contract and which upholds commercially justifiable clauses. Even after the ruling of the European Court of Justice (hereinafter referred to as "ECJ") in the *Aziz* case[2], which provides some guidance on a similar matter, English courts, unlike other European courts that will be briefly discussed, have continued ignoring EU law. In the UK, airlines can limit compensation without restrictions leaving consumers in a very weak position, while consumers should be protected as they can barely influence the content of the contract.

In English law, penalty clauses are unenforceable contractual terms as their main aim is to deter breaches through high amount of damages, mostly disproportionate to the loss suffered. Penalty clauses limit or even annul the liability of one of the parties without providing for any compensation. Due to their complexity, courts often struggle in deciding whether a clause amounts to a penalty or not, creating more questions than answers. Recently, the Supreme Court had to determine whether penalty rules should be abolished altogether or not.[3] The Court admitted that consumer contracts are already regulated by English law implementing EU legislation. Although the Unfair Contract Terms Directive (UCTD)[4] covers similar clauses, English judges invariably avoid referring to the Directive, enabling airlines to avoid compensating passengers.

Despite of being sometimes detrimental to consumers, NSCs are also protecting airlines by enabling the parties to assess with certainty their liability in case of breach. In order to demonstrate that, this article is divided into two parts. The first part introduces NSCs and the law of penalties. The second part analyses and explains the difficulties therewith, arguing that, in multi-leg contract, NSCs should be upheld as reasonable commercial penalties. Indeed, consumers should be protected but not mothered, and the law should be developed with that premise in mind.

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2 Case C-415/11, *Mohamed Aziz v Caixa d´Estalvis de Catalunya, Tarragona i Manresa (Catalunyacaixa)* ECLI:EU:C:2013:164

3 Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Ltd v Beavis [2015] UKHL 67.

4 COUNCIL DIRECTIVE 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts, OJ L 95/29

2. What is all this fuss about in the UK?

Penalty clauses are contractual terms which are not enforceable in courts due to their penal character.[5] Their main aim is the deterrence of breaches through the imposition of high amount of damages, mostly disproportionate to the loss suffered. This definition shares some common features with the EU definition of unfair contract terms and the definition of Article 1 of the Council of Europe Resolution 78(3) on Penal Clauses in Civil Law.[6] The starting point in determining whether a clause amounts to a penalty or not differs. The test under English law focuses on whether the clause is deterring a breach of contract, whereas under EU law, the focus is on the imbalance created.

The difference in approach finds its roots in the origin of the rule. The English jurisprudence on penalties dates back as far as 1720, although the *Dunlop* case[7] is often considered as the first case in this respect. In *Peachy*[8], the House of Lords held that a provision constituting a penalty was unenforceable. Over time, the test evolved.[9] In more recent cases, courts started to consider courts' interventions as an important interference with the freedom of contract.[10] Judges stopped looking at penalties as a standalone principle and started looking at the broader picture. For instance, in the *Philips Hong Kong Ltd v AG of Hong Kong* which endorsed the Canadian case of *Elsey v J.G. Collins Insurance Agencies Ltd*[11],and stated that by interfering too much, courts put the legal certainty that contracts require in jeopardy.

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5 Beale, H. (2012). Chitty on Contracts volume 1 - (31st ed., Sweet & Maxwell, 2012), at p. 26–172.

6 Article 1 of the Council of Europe Resolution 1978: "A penal clause is, […], any clause in a contract which provides that if the promisor fails to perform the principal obligation he shall be bound to pay a sum of money by way of penalty or compensation."

7 Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1914] UKHL 1.

8 Peachy v Duke of Somerset [1720] 1 Strange 447.

9 Morgan, J. (2015). *Great Debates in Contract Law*. Palgrave Macmillan, p. 236.

10 Lord Denning MR *in George Mitchell (Chesterhall) Ltd v Finney Lock Seeds Ltd* [1982] EWCA Civ 5 when referring to the dilemma that English courts are facing when looking at penalty clauses and the freedom of contract. "None of you nowadays will remember the trouble we had - when I was called to the Bar - with exemption clauses. They were printed in small print on the back of tickets […] They were held to be binding on any person who took them without objection. No one ever did object. He never read them or knew what was in them. No matter how unreasonable they were, he was bound. All this was done in the name of "freedom of contract." But the freedom was all on the side of the big concern […] The big concern said, "Take it or leave it." The little man had no option but to take it. The big concern could and did exempt itself from liability in its own interest without regard to the little man. It got away with it time after time. When the courts said to the big concern, "You must put it in clear words," the big concern had no hesitation in doing so. It knew well that the little man would never read the exemption clauses or understand them[…]"

11 Philips Hong Kong Ltd v AG of Hong Kong [1993] 61 Build LR 49; Elsey v J.G. Collins Insurance Agencies Ltd [1978] 83 DLR (3d) 1, 15

The joint appeals of *Cavendish Square Holding BV* and *ParkingEye*[12] gave the opportunity to the Supreme Court to discuss in length the law on penalties. Their Lordships examined the matter according to EU law and came to the conclusion that the UCTD effectively regulates penalty rules. However, the Court felt the need to reformulate the Common law test and clearly establish what constitutes an unenforceable penalty clause. In the Court's opinion, the validity of a penalty clause lays on whether the party seeking to enforce the clause could claim a legitimate interest in its enforcement. In paragraph 32, Lord Neuberger and Lord Sumption stated that *"the true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation […]"*.[13]

The two elements required by the Common law test differ from the EU test. Indeed, the Common law test examine first whether any legitimate business interest protected by the clause exists or not and second, if such legitimate business interest is established, whether the provision does not provide for extravagant or exorbitant compensation. In the Supreme Court's opinion, penalty rules are enforceable if the twofold test is fulfilled.[14] The EU test, based on Article 3(1) UCTD, requires the term to create a significant imbalance to the detriment of the consumer, without any consideration for any legitimate business interest. Therefore, terms considered unfair under EU law could still be enforceable under English law, which leads to a breach of EU law. For instance, in *DGFT v First National Bank plc*[15] the Supreme Court held the EU regulation should be construed tightly and in *OFT v Abbey National plc*[16] the Supreme Court held that if a term related in any way to price, could not, by virtue of Article 6(2) of the regulation, be assessed for fairness. This in turn differentiates English law from continental legal systems, as even in consumer matters, English courts keep a business oriented approach.

Such business oriented approach eases the airlines' job, as they can easily argue that their interest is in the performance rather than in the punishment. By arguing business interest, airlines limit their liability toward passengers and waive their right of compensation. While consumers are the weak party to already-made contracts, and should therefore be protected, their overprotection could have disastrous consequences for airlines. Consequently, especially

[12] [2015] UKHL 67.
[13] At paragraph 32.
[14] Cavendish Square Holding BV v Talal El Makdessi [2015] UKHL 67.
[15] [2001] UKHL 52
[16] [2009] UKSC 6

situation a), namely when the passenger wants to start his journey at the connecting airport, protects the airlines from abusive behavior on the side of consumers.

3. The difficult question of the no-show clauses

NSCs were created to protect airlines by obliging travellers to perform their part of the contract and allowing airlines to escape liability when consumers breach their obligations. The debate as to whether NSCs should be abolished or not has never ended. In the situation b), when the passenger missed the outbound flight of a round-trip itinerary, NSCs are abusive clauses as airlines withhold a sum of money in the form of an outbound ticket and therefore should be abolished. However, in the situation of multiple-leg journey, NSCs protect airlines as well as passengers of 'smaller' airports.[17] For instance, flights departing from Brussels to non-EU destinations are on average 200 euros cheaper than from other major airports. Without NSCs, Dutch passengers will start their journey directly from Amsterdam, leading to a decrease in occupation of certain flights. A ban on NSCs might increase the price or lead to cancellation of routes. For passengers of major airports, the cancellation of some routes will not make a major difference, but for smaller ones it will. NSCs for multi-leg journey are essential mechanisms of pricing policies of airline companies and are therefore necessary.[18] In this situation, NSCs are protecting the airlines, by avoiding sending *quasi*-empty planes, and passengers of smaller airports.

Although in airlines' opinion, NSCs are crucial, they also waive the right of compensation of passengers and limit airlines' liability. As argued by Koning and agreed by the author, NSCs breach Article 3(1) UCTD, demonstrating the limitation of liability that exists.[19] Article 3(1) UCTD defines an unfair term as a contractual term that, *"contrary to the requirement of good faith, causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."* The ECJ interpreted the 'contrary to the requirement of good faith', in the *Aziz* case, which only offers general guidance for NSCs. The ECJ took a somewhat English approach of the reasonable man by asking whether the seller

[17] Boulet, J. and others (May 2015). The EU Public Interest Clinic and BEUC present: Eliminating airline "No-show clauses" in the EU. HEC-NYU EU Public Interest Clinic.
[18] Bischoff, G. *et al*. (2009) 'Airline Pricing Strategies Versus Consumer Rights – Is there a Need to Maintain the 'Full and Sequential Use of Flight Coupons' Rule?'. Abu Dhabi: 13th Air Transport Research Society (ATRS) World Conference.
[19] Koning, I. (2011) The Enforcement of Air Passenger Rights in Europe. *REDC* 2, pp. 359-382.

could reasonably assume that the consumer would have agreed on the term if the contract was individually negotiated.[20]

The test of 'contrary to the requirement of good faith' looks at what the parties would have done whereas the test of 'significant imbalance' focuses on national law. National courts evaluate to what extent *"the contract places the consumer in a legal situation less favourable than that provided for by the national law in force"*.[21] The ECJ further clarified 'significant imbalance' in *Constructora Principado v. Álvarez*.[22]

4. Limitation of liability and waiver of compensation

Due to their far reaching consequences, namely the waiver of compensation, under the civil law doctrine, penalty clauses are enforceable only if they intend to encourage performance, subject to mitigation from courts if such a clause is "manifestly excessive".[23] Allowing penalty clauses implies the existence of a wrongful conduct or fault. Without fault there is no conduct worthy of punishment. When fault becomes irrelevant the need for punishment seems to vanish with it. Cancelling the reminder of the flight for non-appearance is a matter of major and minor breaches. Minor breaches don't allow disaffirmance of a contract, while major breaches do. Since the airline has been paid, and on the top of that can easily resell the seat, the breach cannot be a major one. Therefore, the penalty clause operates to render a minor breach major, thus contravening the law as it would be applied in England.

Generally, in a legal context, a liability is a responsibility to compensate for some failure to perform according to an established or agreed-upon stipulation. Applying this NSCs, the passenger's obligation is to pay the required price in exchange for the company's agreement to carry the passenger for a contracted trip. NSCs allow airlines not to fulfil its part of the contract and escape their liability. Generally, in all European jurisdictions, the defaulting party should compensate the injured party.[24] By reserving the right to refuse compensation, NSCs create a significant imbalance in the meaning of UCTD.

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[20] *Aziz* case Paragraph 69.
[21] Paragraph 68.
[22] Case C-262/ 12, Constructora Principado SA v José Ignacio Menéndez Álvarez, ECLI:EU:C:2014:10
[23] For instance: Articles 1226 to 1233 of the French Civil Code; Article 1154 of the Spanish Codigo Civil; Articles 340 and 341 of the BGB (German Civil Code); Article 3851 of the Polish Civil Code
[24] Junwei Fu, 'Modern European and Chinese Contract Law: A Comparative Study of Party Autonomy' (Kluwer Law International, 2011)

The NSCs are abusive clauses as their application advantages airlines without obliging them to restitute the price of the ticket, except for airport charges. While the passenger is left with no return ticket and the obligation to buy another ticket at a highest rate, assuming one is available, airlines have the possibility to resell the ticket, receiving two-time money for the same seat. This possibility allows airlines to enrich themselves while stepping on the right of compensation or at least reimbursement of the return ticket of passengers. Indeed, the contract requires for passengers to pay the required price in exchange for the company's agreement to carry them for a contracted trip. Therefore, if the company does not carry the passengers, the passengers should be reimbursed or compensated.

Another perspective, advocated by the airlines to fit NSCs within the civil law approach to penalty clauses, exists; passengers paid and agreed to fully use the services provided by the airline. Under this perspective, the defaulting party is the passenger, who is therefore not entitled to compensation as otherwise he would gain from his own fault. Under this approach, NSCs are penalising passengers who refused to perform their obligations, encouraging performance and deterring breach of a contract.

Courts in Spain, Austria and Germany have ruled that the clauses were unfair contract terms.[25] For instance, the German courts view NSCs as creating a disproportionate disadvantage to the consumer and therefore are unjust penalty.[26] Spanish courts, especially after the *Aziz* case, have been particularly progressive in consumer law with two decisions worth mentioning and comparing to English law. Similarly to English law, Spanish consumer law uses the same wording as the UCTD.[27] Unlike English courts, however, Spanish courts closely follow the rulings of the ECJ, as exemplified in the *Iberia* case.[28] Under Article 95 of Spanish law on

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[25] Austria: Oberster Gerischtshof, *VKI v Lufthansa*, 24 January 2013.
Germany: AG of Köln, 05/01/2005 (JurionRS 2005, 26152); AG of Frankfurt, 21/02/2006; Langericht Frankfurt Am Aim, 14/12/2007 (2-2 O 243/07); Oberlandesgericht of Frankfurt, 18 December 2008 (16 U 76/08); BGH, 29 April 2010 (Az. Xa ZR 5/09).
Spain: Commercial court of Bilbao, 7 July 2008; Commercial court of Bilbao, 25 July 2008; Sentencia del Juzgado de lo Mercantil de Bilbao de 3 julio 2009 (AC 2009/1802); Audiencia Provincial of Madrid, 27/11/2009, (JUR 2010/70248); Commercial Court n. 2 Barcelona, 22 March 2010; Sentencia del Juzgado de lo Mercantil nº 2 de Palma de Mallorca, de 22 marzo 2010 (00071/2010); Juzgado Mercantil n 1 Barcelona, *OCU v Spanair* 31 July 2012; Juzgado Mercantil n 12, Madrid , *OCU v Iberia* 11 September 2012.

[26] Case against British Airways, BGH judgment of 29 April 2010 (Xa ZR 5/09), paras. 12-13 and 32-34. But also: AG of Köln, 05/01/2005 (JurionRS 2005, 26152); Langericht Frankfurt Am Aim, 14/12/2007 (2-2 O 243/07); Oberlandesgericht of Frankfurt, 18 December 2008 (16 U 76/08). See: Bischoff, G. *et al*. (2009) 'Airline Pricing Strategies Versus Consumer Rights – Is there a Need to Maintain the 'Full and Sequential Use of Flight Coupons' Rule?'. Abu Dhabi: 13th Air Transport Research Society (ATRS) World Conference, p.9-11

[27] El Real Decreto Legislativo 1/2007, de 16 noviembre.

[28] Juzgado de lo Mercantil No12 de Madrid, sentencia 254/2012 *OCU v Iberia*.

aviation, the only obligations of passengers are to pay the price and determine the dates, then passengers has the right to use the ticket or not.[29] In the *Iberia* case, the Madrid court found that the loss of the entire ticket was disproportionate and unjustifiable.[30] Under the Common law test, the court would ask itself whether there is any legitimate business interest protected by the clause. If a legitimate business interest is established, the court would assess whether the provision provides for extravagant or exorbitant compensation or not. Consequently, unlike under Spanish or EU law, it is not sure whether the clause would be struck down or not. In another judgment, a Spanish court stressed that the major problem flowing from the use of NSCs was that airlines can resell the same seat to persons on the waiting list, while the burden for the passenger to use the seat he bought is disproportionately high.[31]

The author believes that the most probable approach English courts would follow in connection to NSCs would be similar to the approach in *Azimut-Benetti SpA v Healey*.[32] Clarke J was in favor of upholding the clause and stated that commercially justifiable clause should be enforceable as long as the purpose of the clause is not to deter the other party from breaching the contract.

The fundamental question is whether the contract imposes a duty on the passenger to appear in the first place. If no such duty exists, then non-appearance isn't even a breach of contract. Without a breach, treating the failure as a major breach would be manifestly unfair. Consumer protection has been established because of the unequal bargaining position of the parties. Preventing abuse by the airline, which drafts the ticket contract, should thus always be the focus. However, consumers should not be overprotected. In specific cases, such as NSCs, they aim at protecting airlines as well, as their collapses create disastrous results.

5. Conclusion

Even though the ECJ gave its interpretation on the 'contrary to the requirement of good faith' in the *Aziz* case, no case on NSCs never reached the Court. Under English law, there is no certainty that NSCs are penalties, even if they limit compensation to passengers and exclude airlines' liability. In any event, in specific circumstances such as NSCs, some of these penalty

[29] Article 95 of the Ley 48/1960, de Navegación Aérea. See: Sentencia del Juzgado de lo Mercantil nº 2 de Palma de Mallorca, de 22 marzo 2010 (00071/2010).
[30] Paragraph 9 of the judgment Part 4.
[31] Sentencia del Juzgado de lo Mercantil nº 2 de Palma de Mallorca, de 22 marzo 2010 (00071/2010).
[32] [2010] EWHC 2234.

rules should be upheld as they protect airlines from consumers' abusive behavior. If penalty rules were so easily detectable and NSCs were so detrimental to the consumers, the ECJ and national courts would have already struck them out. Consumers should be protected but not mothered. Indeed, if passengers want to buy cheaper tickets, they also need to bear the disadvantages that come with it. It is not the role of the legislator or the judiciary to make sure that the consumers only get advantages. In this complicated relationship, NSCs in the situation a), when the passenger missed the first leg of a multi-leg itinerary, should not be banned to keep the industry going and avoid price increases, while the situation b), when the passenger missed the outbound flight of a round-trip itinerary, is an abusive clause that should be abolished.