

Court of Appeal puts default interest rate clause to the test in *Houssein v London Credit Ltd* (2024)

Two important issues in the context of financing transactions were considered by the Court of Appeal in the recent decision in *Houssein & Others v London Credit Limited & Another* [2024] EWCA Civ 721 (28 June 2024):

1. whether the contractual default interest constituted an unenforceable penalty – the High Court at first instance having found that the default interest rate of 4% per month to be unenforceable as a penalty; and
2. should the default interest not be enforceable, whether non-default interest would continue to accrue after the repayment date.



The facility in question set out an interest rate of 1% per month, which increased to 4% per month compounded monthly on either the occurrence of an event of default or non-payment. The lender alleged that the borrowers had breached a covenant not to occupy one of the properties charged as security for the loan and demanded repayment of the loan with default interest. The borrowers challenged the default interest rate on various grounds.



On the first issue, the Court of Appeal referred to *Cavendish Square Holdings BV v Makdesi* [2015] UKSC 67 and *Cargill International Trading PTE Ltd v Uttam Galva Steels Ltd* [2019] EWHC 476 (Comm). The Court held that when answering the question of whether a provision amounted to a penalty, the threshold question was whether the default rate of interest was a secondary obligation engaged by breach of a primary contractual obligation. If yes, it then needs to be determined whether a legitimate interest is served and protected by the clause. If there is such a legitimate interest, the default interest provision can still amount to a penalty if it is nevertheless extravagant, exorbitant or unconscionable in the circumstances.

Useful context for these considerations can be found in the statements of Lords Neuberger and Sumption in *Cavendish*, that “[t]he 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. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance...”. The Court held that it is self-evident that a lender has a good commercial justification for charging a higher rate of interest after a payment default because, having defaulted, the borrower is a greater credit risk.

However, the Court held that the judge at first instance had not addressed the question of whether the default interest was extortionate, extravagant or unconscionable, and remitted the issue of whether the default interest rate constituted a penalty back to the first instance judge to decide on application of the correct test.



On the second issue, the Court of Appeal held that the High Court was wrong in finding that interest continued to accrue after the repayment date at the non-default rate of 1% per month, and that in the absence of default interest being payable, the non-default rate under the facility letter was not payable.

The Court of Appeal's interpretation of the facility letter was that the default interest rate became applicable if an event of default occurred or if the borrower failed to repay any amount on its due date, but there was no mechanism for the interest rate to revert to the non-default rate in circumstances where the default rate would apply but the provision is found to be unenforceable (the non-default rate and the default rate were mutually exclusive). The Court said that if the default rate of interest is found to be a penalty, in the circumstances of this case, the non-default rate of interest would not apply on the sums outstanding after the repayment date. However it acknowledged that the lender could choose to pursue their counterclaim for statutory/equitable interest in such circumstances.

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