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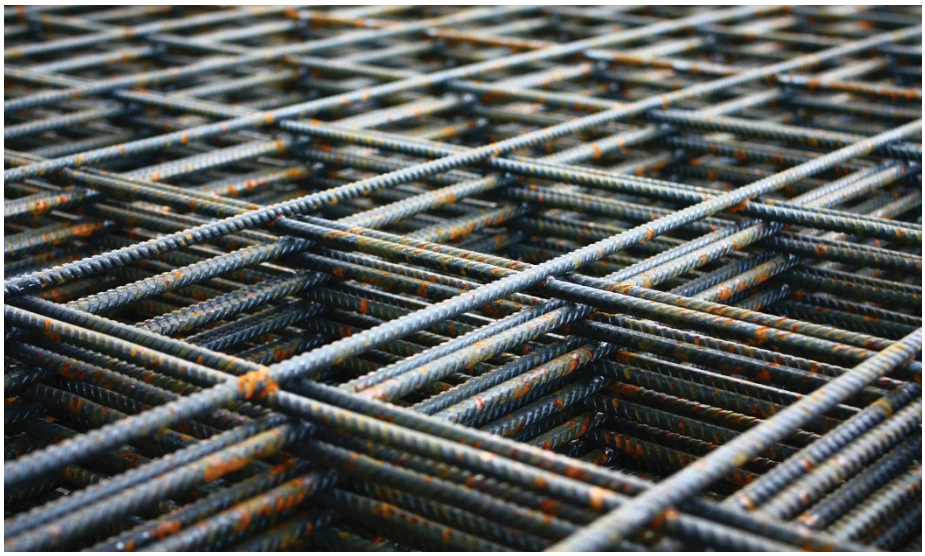
BRIEFING

DEFAULT INTEREST, PENALTIES AND ILLEGALITY UNDER FOREIGN LAW

MARCH 2019

- ENGLISH HIGH COURT HOLDS THAT THERE WAS COMMERCIAL JUSTIFICATION FOR DEFAULT INTEREST RATE
- DEFAULT RATE WAS NOT A PENALTY OR INVALID DUE TO ILLEGALITY



An important decision by the English Commercial Court[1] has clarified the law on whether a default interest clause constitutes a penalty and the operation of illegality under foreign law. These issues are significant in the context of international financing agreements, which commonly include default compensation provisions.

"INTERNATIONAL FINANCING AGREEMENTS ... COMMONLY INCLUDE DEFAULT COMPENSATION PROVISIONS."

In this case, the claimant, Cargill International Trading Pte Ltd, entered into two Advance Payment and Steel Supply Agreements (the "Agreements") with the defendant, India's Uttam Galva Steels Ltd. The Agreements were intended to give greater liquidity to Uttam, a steel manufacturer. Subsequently, the Indian steel industry experienced difficulties and Uttam would later cite this downturn as the reason why it was unable to repay the advance payments made by Cargill under the Agreements.

The parties had what was described as a "cordial business relationship since about 2005" and the terms of the Agreements were similar to those of other agreements made between the parties over the previous decade. The total amount of the financing facility under the Agreements, which came to US$61.8m, had been drawn down by Uttam. However, Uttam did not repay any of this by way of selling and delivering products to Cargill, or through making repayment in cash in advance of the maturity dates or at any time thereafter. Prior to the application in question, the claimant had obtained a judgment in its favour for the US$61.8m which was to be repaid by the defendant. Clause 8.12 of the Agreements provided that, if Uttam

[1] *Cargill International Trading PTE Ltd v Uttam Galva Steels Ltd* [2019] EWHC 476 (Comm)

failed to pay by the maturity dates, then default compensation would accrue on the outstanding amount until it was settled at the rate of one month LIBOR plus 12%.

Cargill therefore made an application for summary judgment on its claim for default compensation under clause 8.12 of the Agreements. Uttam did not dispute the fact that the Agreements made provision for the payment of default compensation but it raised two main arguments against payment.

"THE OBLIGATION TO PAY DEFAULT COMPENSATION UNDER CLAUSE 8.12 WAS A SECONDARY ONE."

Was the default interest clause a penalty?

In dealing with this argument, Mr Justice Bryan cited the leading case on whether a contract term constitutes a penalty - *Cavendish Square Holding BV v Makdessi*[2]. The parties agreed that the obligation to pay default compensation under clause 8.12 was a secondary one, that is, one which arose out of the defendant's failure to meet its primary obligation which was to repay the advance payments. The decision in *Cavendish* was covered in a previous WFW briefing note that be viewed here.

Various tests were put forward in *Cavendish*, however, in this case the judge applied the two-part test set out by Lord Mance whereby, to ascertain whether a term is a penalty, the following should be considered:

1. What business interest is being served and protected by the clause?
2. Assuming the above interest exists, is the provision extravagant, exorbitant or unconscionable in the circumstances?

In answering the first limb of the test, Mr Justice Bryan stated that it was self-evident that there was a good commercial justification for charging a higher rate of interest on an advance of money in light of a default in repayment. This was due to the fact that, upon defaulting, a debtor becomes a greater credit risk than before, and the judge cited the principle that "money is more expensive for a less good credit risk than for a good credit risk"[3]. He also found that the evidence indicated that this was the motive behind the inclusion of clause 8.12 in the Agreements.

Furthermore, the judge found that the rate of one month LIBOR plus 12% was not outside the norm in the context conditions in the Indian steel market, having assessed evidence relating to default interest payable by companies comparable to Uttam. This rate was not held to be exorbitant outside of those conditions either, which was illustrated by comparing this rate of interest with that in other cases where relatively high interest rates have been held not to constitute a penalty. It was also noted that the parties were both sophisticated and that the Agreements had been freely negotiated.

Was the default interest clause invalid due to illegality?

Uttam also sought to argue that clause 8.12 was illegal under Indian law, owing to the fact that such a term would not be in accordance with regulation 15 of the Reserve Bank of India's Foreign Exchange Management (Export of Goods and Services) Regulations 2016. The judge made it clear that in the case of contracts such as these, which are expressly governed by English law, illegality under Indian law would only be relevant if it would render the contract unenforceable under English law. The defendant sought to rely on the rule in *Ralli Bros v Compania Naviera Sota*

[2] [2015] UKSC 67
[3] Lordsvale Finance Plc v Bank of Zambia [1996] QB 952

y Aznar[4] which states that, where a contract requires a party to do something unlawful in the place where the contract is being performed, then that obligation is unenforceable.

However, Mr Justice Bryan highlighted that this rule only applies if the contract actually requires performance to be done in a specific place, and performance in that place would be illegal. In this case, the Agreements required that Uttam pay default interest to an account held in Singapore, not India. Though the defendant argued that payment of interest would be made through their bank accounts in India, the judge held that the rule in *Ralli Bros* did not apply as an obligation to pay funds into a specified account is performed in the place where that account is located, not the location of the payer[5]. In any event, the judge preferred the evidence put forward by Cargill's expert and found that clause 8.12 was not illegal under Indian law.

Therefore, it was held that Cargill was entitled to summary judgment with respect to the default interest claimed.

"RELATIVELY HIGH RATES OF INTEREST PAYABLE UNDER A DEFAULT COMPENSATION CLAUSE WILL NOT NECESSARILY BE DEEMED TO BE A PENALTY."

Conclusion

This judgment confirms that relatively high rates of interest payable under a default compensation clause will not necessarily be deemed to be a penalty. Moreover the judgment clarifies that, in assessing whether sums are in proportion to a legitimate interest, market conditions can be examined, both within an industry and a country where the debtor is located. The judgment also provides a helpful analysis of the principles governing alleged illegality under foreign law and how these principles might be applied by the courts of England and Wales.

In the context of natural resources, this judgment will be of particular interest to clients operating within the sector, especially as a party to similar financing agreements which include a default compensation clause. Importantly, it remains somewhat unclear under what circumstances, and how high interest payable under such a clause would need to be, in order for it to be considered a penalty.

[4] [1920] 2 KB 287
[5] *Dana Gas PJSC v Dana Gas Sukuk Ltd* [2017] 2 CLC 735

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.

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