

Enforceability Of Default Interest Clauses In Loan Agreements: Key Takeaways From *Houssein Vs. London Credit Ltd.* And The Application Of The Makdessi Test

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Introduction

In *Houssein vs. London Credit Ltd.*¹, the Court of Appeal examined the enforceability of default interest clauses within loan facility agreements, specifically whether such clauses constitute unenforceable penalties. The decision highlights the importance of careful contractual drafting and the rigorous application of established legal tests to determine the validity of default interest clauses.

To appreciate the Court of Appeal's decision, it is essential to revisit the existing judicial precedents from English Courts governing liquidated damages. A liquidated damages clause providing for amounts in the nature of penalty is traditionally considered unenforceable if it imposes a detriment on the breaching party that is disproportionate to the legitimate interest of the innocent party. The relevant case in this domain is *Cavendish Square Holding BV vs. Talal El Makdessi*², which established a three-part test to determine whether a clause provides for an unenforceable penalty:

1. Secondary Obligation: The clause in question must be secondary in nature and is triggered only by a breach of the primary contract terms. This is a threshold requirement that must be satisfied before moving to the other elements of the test.
2. Legitimate Interest: The innocent party must have a legitimate interest in the performance of the primary obligation, which the clause seeks to protect. This interest must go beyond simply punishing the breaching party.
3. Proportionality: The clause must not impose a detriment that is "extortionate, exorbitant, or unconscionable". The Court will examine whether the penalty is out of proportion to the legitimate interest it seeks to protect.

The Court of Appeal's task in *Houssein*³ was to apply this test to the default interest clause at issue and determine whether it crossed the line into unenforceability.

Brief Facts

The case originated from a facility agreement between the borrower, and London Credit Limited ("**LCL**"). The agreement stipulated that in the event of a default, the borrower would be required to pay not only the principal amount of the loan but also a higher rate of interest, known as "default interest", on the outstanding sums until the breach was remedied. When the borrower allegedly breached the covenant in the agreement, LCL demanded repayment of the loan and the default interest. The borrower failed to pay the sums demanded by the repayment date specified in the agreement, prompting LCL to appoint receivers to liquidate

¹ [2024] EWCA Civ 721.

² [2015] UKSC 67.

³ [2024] EWCA Civ 721.

the security furnished by the borrower. In response, the borrower initiated legal proceedings, challenging the enforceability of the default interest clause.

At first instance, the High Court found that while the borrower had indeed breached the facility agreement, the default interest clause did not protect a legitimate interest of LCL and was thus deemed an unenforceable penalty. As a result, the Court ruled that only standard interest was payable under the agreement even for the timeline beyond the repayment date. Both parties appealed this decision, bringing the matter before the Court of Appeal.

Decision

Whether the default interest clause was enforceable?

The primary issue in the appeal was whether the High Court had correctly applied the **Makdessi**⁴ test in determining that the default interest clause was an unenforceable penalty. The Court of Appeal found that the High Court had erred in its approach, particularly in its application of the second limb of the test, which concerns the protection of a legitimate interest.

The Court of Appeal emphasised that LCL, as a lender, had a legitimate interest in ensuring the timely repayment of the loan, particularly given the increased risk associated with a borrower who has already defaulted. This interest justified the imposition of a higher rate of interest. The Court criticised the High Court for conflating the existence of a legitimate interest with the effect of the clause rather than focusing on the clause's purpose and justification.

Moreover, the Court of Appeal noted that the High Court had taken an overly subjective approach to interpreting the contractual clause. The correct approach, as established in **Makdessi**⁵, is to assess the purpose of the clause objectively within the context of the contract as a whole. The commercial context, while relevant, should not override the objective construction of the clause's purpose.

Having clarified the correct application of the **Makdessi**⁶ test, the Court of Appeal concluded that LCL did indeed have a legitimate interest in securing repayment of the loan and associated fees, which the default interest clause was designed to protect. However, the Court refrained from ruling on whether the clause was "*extortionate, exorbitant, or unconscionable*", deciding instead to remit this question to the trial judge for further consideration.

What would be the interest after the repayment date?

The second issue in the appeal concerned the payment of interest after the repayment date, particularly if the default interest clause was deemed a penalty. The Court of Appeal examined the facility agreement's provisions in detail, focusing on the interplay between the standard interest clause and the default interest clause.

⁴ [2015] UKSC 67.

⁵ [2015] UKSC 67.

⁶ [2015] UKSC 67.

The Court agreed with the borrower that the standard interest clause did not automatically apply after the repayment date if the default interest clause was found to be unenforceable. The facility agreement explicitly distinguished between the two interest rates, specifying that they were mutually exclusive. The Court rejected the argument that the standard rate could serve as a fallback if the default rate were invalidated, highlighting the importance of clear and precise contractual language.

The Court of Appeal's analysis highlights the need for careful drafting and a thorough understanding of the implications of each clause in a loan facility agreement, particularly in scenarios where the enforceability of a penalty clause may be challenged.

The Court of Appeal's decision in ***Houssein vs. London Credit Ltd.***⁷ offers several important takeaways for financial institutions, legal practitioners, and borrowers involved in drafting and enforcing loan facility agreements. *Firstly*, the case highlights the critical importance of clear and precise contractual drafting. Lenders must ensure that their facility agreements are meticulously drafted, with a clear distinction between standard and default interest rates. This clarity will help avoid disputes and ensure that the agreement accurately reflects the parties' intentions. *Secondly*, the decision reinforces the importance of correctly applying the ***Makdessi***⁸ test when assessing the enforceability of penalty clauses. Legal practitioners should be vigilant in ensuring that all three limbs of the test are addressed separately and that the legitimate interest of the innocent party is clearly articulated and proportionate to the detriment imposed by the clause. *Thirdly*, financial institutions should be aware of the risks associated with default interest clauses and take steps to mitigate these risks. This includes regularly reviewing and updating facility agreements to ensure they comply with current legal standards and reflect best practices in the industry.

Comment

The Court of Appeal's ruling provides valuable guidance on the enforceability of default interest clauses. The decision reaffirms the importance of protecting a lender's legitimate interest in securing repayment while ensuring that penalty clauses are not disproportionate to this interest.

⁷ [2024] EWCA Civ 721.

⁸ [2015] UKSC 67.

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