A GUIDE TO LATE PAYMENT OF COMMERCIAL DEBTS

1. Background

Late payment of commercial debts has long been a problem for companies operating in the UK. In contrast to the Scandinavian countries, in the UK (in effect England and Wales[1]) no statutory right to charge interest on late payments has existed until recently[2].

Historically, about a quarter of Britain's annual business failures are due to delays in payment. Small businesses were usually worst affected. Payment of interest could only be catered for it was provided for in the contract between the parties or if proceedings were issued for recovery of the debt and the court awarded interest.

In an effort to redress the situation, in November 1998, the British government introduced a law specifically granting the right to claim statutory interest on late payment of commercial debts. The law has been introduced in three stages. None of these stages are retroactive; meaning that they only apply to contracts entered into after their effective dates. In the first stage, the law was applicable only to small businesses, i.e., companies with less than 50 employees that were granted the right to claim interest from larger businesses and the public sector. Stage 2 permitted small businesses to charge each other statutory interest as well. Finally, stage 3 extended the scope of the new law to all other businesses.

2. Scope of the Law

Essentially, the law applies to all commercial contracts carried out in the course of business. However, consumer credit agreements, mortgages and pledges are specifically excluded.

2.1. Interest rates

The current prescribed rate of interest is 8% above the base rate (at the time of writing the base rate is 1% so the statutory prescribed rate is 9%). However, the legislation provides that any contractually agreed provisions will override the new legislation, but to prevent purchasers abusing the right to agree to their own arrangements, any contractual remedy must be "substantial" otherwise it will be considered void and the new legislation will apply instead. Basically, "substantial" has been interpreted by the Department of Trade and Industry as compensation to (i) cover the supplier for losses incurred due to late payment or to act as a deterrent (ii) it is reasonable to let the contractual compensation replace the provisions of the law.

In determining whether the late payment provisions of an agreed contract are reasonable, the courts will consider all the circumstances, taking into account such factors as the actual interest rate, the length of credit periods, whether standard terms have been imposed and the equality of the bargaining position between the parties.

[1] In Northern Ireland and Scotland, the late payment legislation is similar. However, due to differences in legal proceedings and the impact of devolution, appropriate advice should be sought when necessary.
[2] Meaning: in order to be able to charge interest on a late payment this had to be specifically included in the relevant contract.

2.2. Credit periods

The parties are also free to agree to the length of the credit period. If no credit period has been agreed, the new law sets a default period of 30 days after which interest can run. The 30-day credit period starts to runs from the later of either (i) the delivery of the goods or performance of the service, or (ii) the day the purchaser receives notice of the debt. Thus, a payment is late once the agreed credit period or the default period has expired.

2.3. Debt Recovery costs

Another new development is that in addition to interest creditors will now be able to claim compensation for debt recovery costs. Presently, the statutory compensation for debt recovery costs is £ 40 for debts up to £1,000, £ 70 for debts between £ 1,000 and £ 10,000 and finally, £ 100 for debts above £ 10,000.

3. Implementation

The practical experience of the implementation of step one of the new law was not altogether positive. In fact, most small businesses were reluctant to use the law, because they did not want to alienate big customers[3]. Another consequence was that big customers increasingly insisted on being allowed 60 days to pay.

However, there are reasons to believe that this is now changing, following the full implementation of the law, on 7th August 2002, the date from which the late payment legislation began to apply to all transactions and businesses, regardless of size. Enforcement of the new law is expected by the legislature to become standard practice. It is hoped that more companies will take advantage of their statutory right to interest on late payments, and thereby indirectly promote a better payment culture.

4. Recommendations

It is important for companies doing business in the UK to take advantage of the opportunities that the full implementation of the new legislation offers. Some of the more obvious measures that should be considered include (i) updating credit management policies so that customers are notified from the outset that the legislation will be used; (ii) amending credit management documentation, such as contracts, invoices and reminder letters so that these documents clearly state the intention to use the legislation. For example:

"We reserve the right to claim statutory interest at 8% above the Bank of England base rate at the date the debt becomes overdue in accordance with the Late Payment of Commercial Debts (Interest) Act 1998."

It may also be worthwhile reviewing contracts with suppliers to check if (i) they have reserved the right to claim late payment interest; (ii) if a revised credit period has been suggested; and/or (iii) if any alternative remedy that has been suggested is acceptable.

Another factor which it is important to consider is that the law allows separation and assignment of the interest. The practical consequences are that any part of the debt (i.e., the interest or the principal or both), can be sold or assigned to third parties. Moreover, the compensation for debt recovery costs can also be assigned. The third party, regardless of its size, can then pursue the debtor through the courts for interest etc. This minimizes the risk of a creditor damaging valuable customer relationships.

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[3] The Daily Telegraph, Monday, 22nd November, 1999 at 31.

5. Conclusions

Although seasoned observers are of the view that the introduction of the new legislation has not been an outright success[4], there are many reasons to believe that this will change with the full implementation of the law. As the law now affects all businesses it is expected to have the effect that the very existence of the implied term and penal rate of interest will induce businesses to accept standard procedures to ensure prompt payment.

The creditor can simply notify the debtor orally that interest will be claimed. However, it is advisable to put it in writing. Such a letter should include the following information:

- the amount owed, including the total interest accrued at the date of the letter;
- the continuing daily interest rate;
- the original invoice details;
- the full name and address to whom payment should be made; and
- the method of payment.

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[4] Ibid.