WHITE & CASE

Insight

April 2013

New Changes to the Late Payment of Commercial Debts (Interest) Act

On 16 March 2013, new regulations came into force in relation to the Late Payment of Commercial Debts (Interest) Act.

Enacted to incorporate a recent EU Directive, these new regulations introduce a maximum payment period of 30 days into commercial contracts with public authorities and a default 60 day payment period into business to business commercial contracts.

Parties to business to business contracts may agree to payment periods which are longer than 60 days provided that the arrangement is not "grossly unfair" to the supplier. If such a provision is grossly unfair, parties will find their terms unenforceable and replaced by the statutory provisions, with interest being due at 8% above base rate on sums overdue after 60 days.

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Background

In 1998, the Late Payment of Commercial Debts (Interest) Act came into force (the "**Act**"). The purpose of the Act was stated at the time of its Second Reading as a Bill in the House of Lords as:

> *"…to encourage customers to pay on time, thereby working to eliminate the costly late payment problem. …* [S]*hould late payment persist the supplier will be able to claim interest to cover the increased cash flow risk caused by late payment. The cost will no longer be borne by the supplier but by the late paying customer…"* [1]

The Act applies to commercial contracts for the supply of goods and services. This excludes consumer credit agreements, mortgages, pledges, charges or other security.

Late payments were also recognised at an EU level as a significant risk to business and in 2000, the EU adopted its first Directive on Late Payment, designed to combat late payment in commercial transactions across the Member States, which was subsequently incorporated into the Act in 2002 by the Late Payment of Commercial Debts Regulations 2002. The changes to the Act included the ability of suppliers to claim one-off fixed compensation sums on overdue debts.

1 Lord Clinton-Davis, the then Minister of State, Department of Trade and Industry (Hansard, HL Vol. 584, col. 846, 12 January 1998).

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In 2008, the EU announced that, despite some improvement, late payment still remained a problem affecting, in particular, the viability of SMEs.[2] The EU also acknowledged that public authorities were often the worst culprits and that, instead, they should be leading by example. The EU adopted Directive 2011/7/EU on 16 March 2011 (the "**New Directive**"), which repealed and replaced its predecessor, with the intention of combatting the culture of late payments in commercial transactions within the EU, by providing common minimum legislative requirements. The UK Government has said that it supports the improvements as creating "a level playing field" across the EU.

The New Directive required various changes to be made to the previous regime, including the introduction of the time periods for payment after which interest will be due. In accordance with this, the UK Government enacted the Late Payment of Commercial Debts Regulations 2013 (the "**2013 Regulations**"), incorporating the provisions of the New Directive into English law.[3] The 2013 Regulations took effect on 16 March 2013.

The 2013 Regulations

The 2013 Regulations apply to contracts entered into <u>from</u> 16 March 2013 onwards only and make changes to the Act by introducing the following:

a) Payment Periods

b) Acceptance Processes

c) Concept of Gross Unfairness

d) Recovery of Costs

Payment Periods

The 2013 Regulations introduce, in effect, new default payment periods for sums due under commercial contracts by providing that interest will be due on those sums after the expiry of the applicable period.

For business to business contracts, that period is 60 days, and for business to public authority[4] contracts (i.e. where the public authority is the purchaser) the period is 30 days.

Both periods will run from the latest of either:

a) The date the invoice is received; or

b) The date the goods or services are received; or

c) Acceptance of the goods or services where provided for in the contract.

Where a contract is silent on payment periods, these provisions will apply by default. Parties to a business to business contract may agree to payment periods which are longer than the default period of 60 days provided that the extended period is not "grossly unfair" to the supplier.

Acceptance Processes

Some contracts will contain express provisions for the purchaser to test goods supplied to verify that they comply with contractual requirements before they are accepted and payment becomes due. In these circumstances, the 2013 Regulations provide a default maximum period for a verification process of 30 days.

In this situation, the payment periods already mentioned will only begin to run once such an acceptance process has been completed. As a result, payment under a contract to supply goods to a public authority could be extended to 60 days, and to a business, 90 days after goods are received.

As with the payment periods, contracting parties may agree to acceptance processes taking longer than 30 days, provided again that the extended period is not "grossly unfair" to the supplier.

Concept of Gross Unfairness

Section 2(5) of the 2013 Regulations contains a broad definition of the term "grossly unfair" as applied in its preceding sections on payment periods and acceptance processes (sections 2(3C) and 2(5C) respectively). It states:

> *"In determining…whether something is grossly unfair, all circumstances of the case shall be considered; and…in particular...*
>
> *(a) anything that is a gross deviation from good commercial practice and contrary to good faith and fair dealing,*
>
> *(b) the nature of the goods or services in question, and*
>
> *(c) whether the purchaser has any objective reason to deviate from the result which is provided for by subsection [2](3B) or [2](5C)."*

The concept of gross unfairness is new to English law. It is defined in the 2013 Regulations, in part, by reference to "good faith" which, in turn, is also not a concept generally recognised in English commercial law.

Most (if not all) other EU jurisdictions, including France, Germany and Italy, recognise "good faith" as an overarching principle that is implied in all commercial dealing. It is therefore not surprising that this concept is included in EU legislation. However, English law proceeds somewhat differently. The English courts will interpret and apply express provisions of good faith in contracts insofar as a reasonable interpretation of the contractual terms will allow, including by implication through statute, but they do not accept an implied term of dealing in good faith in all transactions.[5]

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2 Small and Medium Enterprises.

3 The 2013 Regulations extend to England, Wales and Northern Ireland. Scotland has effected its own statutory instruments to incorporate the New Directive.

4 A public authority has the same definition as a "contracting authority" as set out in regulation 3 of the Public Contracts Regulations 2006 (which can be viewed here).

5 As confirmed by a recent decision in the Court of Appeal: *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (trading as Medirest)* [2013] EWCA Civ 200.

Recovery of Costs

The Act already provided suppliers with the ability to charge a fixed sum of compensation for overdue debts in addition to interest (£40, £70 or £100 depending on the sum outstanding). The 2013 Regulations now go further, so that a supplier is now entitled to recover its reasonable costs in recovering the debt, although this must be netted against the compensation sum(s) applicable.

Territorial Effect

The Act applies to all UK domestic contracts between UK-based parties. However, where a contract involves one or more parties (or actions under the contract being performed) outside of the UK, the territorial effect of the Act is less clear.

Section 12(1) of the Act provides that, where parties have chosen a law of part of the UK (e.g. England) as the applicable law to their contract, the Act will not apply where:

a) There is no significant connection between the contract and that part of the UK; and

b) But for the parties' choice to apply the law of part of the UK, the applicable law to the contract would be a foreign law (that of a country outside the UK).

Section 12(2) of the Act provides that where parties have chosen a foreign law as the applicable law of their contract, the Act will still apply where:

a) But for the parties' choice to apply a foreign law, the applicable law to the contract would be the law of part of the UK; and

b) There is no significant connection between the contract and any other country, other than that part of the UK.

What constitutes a "significant" connection to a particular jurisdiction will depend on the factual circumstances of the contractual agreement and will not always be clear cut. Consequently, particular care should be taken when drafting contracts with an international context as some legal uncertainty may arise. However, in practical terms, this Section of the Act will have the biggest effect where the "foreign" law referred to is that of a country outside the EU, as all EU countries should now have similar laws to the Act, as required by the New Directive.

Section 12 of the Act remains unchanged by the 2013 Regulations.

Implications for the Construction Industry

In an industry where payments terms are frequently extended, particularly towards the lower end of the supply chain, these Regulations may have a significant impact.

Although the Regulations allow parties to commercial contracts to agree payment periods longer than 60 days, this will only be enforceable if the extended period is not "grossly unfair". There is a risk that if contractors impose extended payment terms on subcontractors without negotiation or justification, they could find those terms subsequently challenged in the event of a payment dispute, and face additional claims for compensation, recovery costs, and interest at a higher rate than envisaged under the contract.

It is important to note that the Regulations have made no change to Section 8(2) of the Act, which provides that, where parties to a contract have agreed a substantial remedy for late payment of a debt, the statutory rate of interest will not apply. This would include the payment periods.

It remains to be seen whether the courts will interpret a "substantial remedy" as being one where payment should be made within 60 days or less or how much latitude will be given to commercial parties. The Department for Business, Innovation & Skills has published a "Users Guide" to the 2013 Regulations which includes examples of what may not be considered a substantial remedy, including "a credit period that is significantly different from custom and practice in that industry".

The courts have previously examined rates of interest in the context of a "substantial remedy" under the Act. In *Yuanda v WW Gear Construction*,[6] a rate of interest of 0.5% above base (found on the facts by the judge to have been "imposed" on the supplier) was, held not to be a *substantial* remedy within the meaning of the Act. The rate was found to be unenforceable, and the statutory rate of 8% above base rate was awarded instead. In his judgment, Edwards-Stuart J. commented that the rate allowed in the JCT standard form contract of 5% would be considered reasonable, and that a rate of 3 - 4% above base rate could even be regarded as a substantial remedy, particularly in circumstances where the terms of the contract are negotiated.

Accordingly, in interpreting whether a payment period is reasonable, it could be expected that the courts would similarly take into account the periods allowed in standard form contracts as well as industry norms.

Contractors already working with public authorities should not be greatly surprised as the 30 day payment period already matches the UK Government's targeted best practice, by which all central government departments are required to include clauses in their contracts requiring their contractors or suppliers to pay their

6 [2010] EWHC 720 (Technology and Construction Court)

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sub-contractors and sub-suppliers within 30 days.[7] The UK Government encourages the use of Project Bank Accounts and the Cabinet Office has introduced a "mystery shopper" scheme to investigate poor procurement practices in its supply chains, under which suppliers may anonymously report payment issues.

Conclusion

Businesses entering into commercial contracts after 16 March 2013 should take heed of the 2013 Regulations and pay particular attention to the payment periods, and rates of interest, stipulated in them. Although commercial parties may still negotiate payment periods which are longer than 60 days, it is possible that in the event of a dispute, this may not be considered a substantial remedy for late payment, and will be unenforceable. If unenforceable, suppliers will be entitled to claim interest at the statutory rate of 8% above base rate from 60 days after the debt became due.

7 Although strictly speaking under the Act, a sub-contractor supplying goods to a main contractor, whose employer is a public authority, would only be entitled to a default 60 day payment period, as the sub-contract would be a business to business contract.

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