Under the Late Payment of Commercial Debts Act 1998, a supplier to another business is entitled to charge interest on late payments at a rate of 8% per annum above base rate. This term is implied into contracts for the supply of goods and services between businesses. Any attempt to exclude the provision is void, unless the contract includes an alternative substantial remedy for late payment of a debt.

**When does the Act apply?**

The Act applies to business-to-business supply contracts. It covers contracts where interest provisions have not been agreed by the parties, or where the provision agreed is not a substantial remedy. In effect, it’s the default position.

It applies to "late" payments, which means it is received after:

a. the date for payment agreed by the parties in the contract; or
b. the expiry of any credit period established in accordance with trade custom and practice or by a course of dealing between the parties. For example, where the purchaser usually pays at the end of the month following the month of invoice.

If no credit period is agreed or established then the Act sets a default credit period of 30 days after the later of either:
a. delivery of the goods or services; or
b. the day on which the purchaser has notice of the amount of the debt. This could be the day of receipt of the invoice, or simply a telephone call telling the purchaser the amount due for payment (although that might be harder to prove).

What interest is charged?

Interest is charged at 8% above the Bank of England base rate, plus a fixed "debt recovery" fee of £40-£100 per debt. The proposed amendments to the European legislation won't affect the interest rate, but may impose a single fixed debt recovery fee.

The Act was introduced gradually, as a mechanism to encourage businesses in the UK to pay promptly. The 8% rate, set back in 1998, was supposed to reflect the cost of borrowing and compensate suppliers for any reduction in cash flow due to late payment.

Interest clauses can be set at higher rates than the Act allows, provided it is not at a level which could be considered a penalty. In other words, it must be a genuine pre-estimate of the losses suffered by the supplier. For example, where for specific reasons the cost of borrowing may be higher. In practice, we rarely see higher rates than 8% above base.

Simple v Compound Interest

It is worth bearing in mind that while commercial money lending is likely to be on a compound interest basis, statutory interest is based on a simple interest basis.

"Simple interest" means that interest is calculated with reference to the principal sum owed, but the accumulating interest is not added to it, so the interest each month will be the same.

In contrast, "compound interest" adds accumulated interest back to the principal sum, so that interest is earned on interest from that moment on.

As a general rule, the more frequently the interest is compounded, the higher the interest charge will be. In order to define accurately the amount to be paid, any interest clause must specify both the interest rate and the frequency of compounding (yearly, half-yearly, quarterly, monthly, daily, etc.).

Summary
Charging interest under the Act

- If there’s no interest clause, a supplier can claim 8% above base rate per annum simple interest on late payments, plus a debt recovery fee of £40-£100.
- A payment is late if it is received after the express date of payment or implied credit period. If there is no such provision, it will be late if it is received after 30 days after the provision of the goods or services/receipt of notice of the debt.

Drafting interest provisions

For your clause to be effective, you should include:

- the interest rate, including any base rate, provided it is a "substantial remedy";
- whether the interest is compound or simple;
- if compound, the period over which interest will be compounded;
- the date from which interest will run (a due date for payment, or a clear credit period); and
- any special factors which mean that the clause is appropriate, particularly if it is an unusually high or low rate, which will help the court decide that the clause falls within the regulations.

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