# Circumventing the *In Duplum* Rule

The recession has had a devastating effect on business; with less money circulating in our economy many borrowers have struggled to repay their loans. The *in duplum* rule aims to protect borrowers by preventing lenders from claiming an amount in arrear interest that exceeds the amount of the original loan. Over long periods of time it is common place for a borrower to pay more in interest then the capital amount that he borrowed. However, if payments are not made the accumulated arrear interest that is owed becomes capped once it equals the amount that was first loaned.

Credit providers have been faced with an unprecedented number of borrowers defaulting on their loans. In order to avoid the effect of the *in duplum* rule many lenders have initiated litigation proceeding against those in default. However this approach is costly for all parties involved; many borrowers are forced into liquidation and creditors are left with only a small percentage of the amount owed to them. It may be better for both parties to weather the current economic storm, and avoid the costs of litigation, by circumventing the operation of the rule via novation.

"Novation occurs whenever an obligation is discharged in such a manner that another obligation is substituted in its place."[1] For example "when the parties to a contract agree to extinguish the existing debt and substitute a new debt in its place"[2] In general courts will refrain from inferring that novation has taken place, so it is important for the parties to make an express declaration that they intend to novate.[3]

It has already been established by our courts that it is impermissible for a lender to unilaterally convert arrear interest that is owing into capital in order to avoid the consequences of the rule.[4] It has also been held that "an agreement in advance to waive the rule leaves the debtor exposed to precisely those perceived evils which the rule is formulated to combat."[5] However it also been indicated that novation may be a permissible way of legitimately converting interest to capital.[6]

In order for a novation to be valid, both parties must be aware of the new terms of the agreement

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1 A. A Roberts, *Wessels' The Law of Contract in South Africa 2nd ed vol 2* (Butterworth & CO (Africa) LTD, 1951), para 2369

2 (Note 1), Para 2375

3 *Ewers v The Resident Magistrate of Oudtshoorn* (1880) Foord 32 at 35

4 *Pfeiffer v First National Bank of SA Ltd* 1998 (3) SA 1018, at page 828

5 *Commercial Bank of Zimbabwe Ltd v M M Builders & Suppliers (Pvt) Ltd and Others and Three Similar Cases* 1997 (2) SA 285 (ZH) A 1997 (2) SA, 322

6 *Pfeiffer v First National Bank of SA Ltd* 1998 (3) SA 1018, at page 828

and make a free choice to be bound by them. In a situation where a borrower has not paid the lender the amount that it owes, the lender is within its rights to sue the borrower in order to reclaim the outstanding debt. By presenting the borrower with the option to enter into a new agreement and set aside the existing agreement, the lender is expanding the choices available to the borrower. The borrower was originally faced with either paying the outstanding debt or defending itself against legal action. Now it has the added option of novation.

In addition to respecting the value of freedom of contract, there are three public policy reasons for upholding novated agreements. First, it will sometimes be the case that the borrower will be unable to pay the debt that it owes and it will have to be put into liquidation if it is sued. Widespread liquidations could entail an increase in unemployment and this would have an adverse effect on the economy. If novation is allowed this will be prevented.

Second, the novation would protect the credit record of the borrower. The novation would prevent the borrower from being blacklisted, which in turn would prevent the borrower from being denied credit in the future.

Third, the novation could confer a further benefit on the borrower by extending the time for repayment or altering the interest payable on the loan.

In order for a novation to be legally valid it is important for it to be performed at the correct time. For example if a lender lends R100 to a borrower at the rate of 10% per month and the borrower does not make any payments it will owe the sum of R200 after ten months. At this point the *in duplum* rule comes into operation. If the novation is entered into after the tenth month it would be impermissible for the new agreement to set the capital amount owed at a sum greater than R200, since this would amount to charging interest over and above the rule. "If the old obligation is void, the new contract will not create a valid novation." [7]

A further consideration that needs to be taken into account is the type of interest that is charged. In the above mentioned example, interest was calculated in terms of simple interest. After the novation, if the interest rate remains at the rate of 10% per month the borrower will be required to pay R20 a month, whereas prior to the novation it was required to pay R10 a month. In effect the novation results in the borrower being required to pay interest on the original interest. In principle this should

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7 (Note 1), Para 2380

not be problematic if both parties are aware of the new result. However if the parties intend the new agreement to keep the monthly payment rate the same, the interest rate would have to be halved to 5%. This would have the effect of only requiring the borrower to pay R10 a month.

If a court where to find that a novation was legally impermissible on the grounds that it contravened public policy, it would not be the case that the lender would be unable to recover any money from the borrower. "If the negotiations do not result in a legally valid new debt, there is no novation. Hence, if the new contract is physically or legally impossible, the old obligation is not extinguished."[8] This means that the lender would be able to recover the original amount owing, in addition to interest that does not exceed the *in duplum* rule.

Novation appears to be a suitable method for circumventing the rule without offending public policy. Unlike a unilateral conversion of interest to capital by the lender, novation upholds the value of freedom of contract since both parties must agree to the terms of the new agreement. Furthermore novation has the effect of protecting borrowers by preventing them from being liquidated or blacklisted for defaulting on loans. It also has the possibility of conferring the benefit of an extended repayment schedule or a reduction of the interest rate. Even if novation is found to be against public policy under the original agreement, the lender will be able to claim the amount that was owed, in addition to interest that does not exceed the *in duplum* rule.

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[8] (Note 1), Para 2383