Banking, Finance & Projects

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Court's approach to balancing contractual freedom with protection against unconscionable contract terms

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Court's approach to balancing contractual freedom with protection against unconscionable contract terms

In a recent landmark decision, *Kanwal Sarjit Singh Dhiman v Kenshvaji Jivraj Shah* [2025] eKLR, the Court of Appeal (Court) addressed, among other things, the enforceability of contracts containing exploitative interest provisions. The Court declared the contract in question void on the grounds that its enforcement would result in oppressive and unconscionable consequences.

While reaffirming the general legal principle that courts do not interfere with or rewrite freely negotiated contracts, the Court emphasised that an unconscionable contract will be set aside where its enforcement would undermine principles of fairness, good faith and proportionality. This decision reinforces the evolving judicial approach in Kenya towards scrutinising exploitative contractual provisions and affirms the courts' willingness to intervene where enforcement would result in manifest injustice.

Background

In 1996, Kenshavji Jivraj Shah (the lender) and Kanwal Sarjit Singh Dhiman (the borrower) entered into a loan agreement pursuant to which the lender was to advance to the borrower KES 13 million in three instalments at an interest rate of 36% per annum, compounded quarterly. However, the lender only advanced KES 7 million to the borrower under the loan agreement. The borrower defaulted on his repayment obligations, leading to a protracted legal battle spanning nearly three decades. Over that period, the borrower repaid KES 3 million, leaving a principal balance of KES 4 million which, due to the compounding interest, escalated to over KES 69 billion.

Given that the borrower did not defend the suit that had been instituted by the lender, the trial court, on application by the lender, entered interlocutory judgment against the borrower in the sum of KES. 17,020,365.40 plus interest at 36% per annum from 31 August 1999 until payment in full, plus costs of the suit. The lender then proceeded to attach the borrower's property, which had been charged in favour of the lender as security for the loan, in execution of the decree in his favour. Being the successful bidder at the public auction of the property, the lender obtained a vesting order from the trial court which he used to transfer the property to himself. The borrower then applied to set aside the judgment of the trial court. A retrial of the case was ordered by the Court.

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At the core of the case was whether the terms of the loan agreement were enforceable, or whether they were so oppressive as to be deemed unconscionable. The borrower argued that the interest rate was unconscionable, extortionate and oppressive, and that at the time of signing the agreement he was in a financially vulnerable position, which the lender had exploited.

The lender, on the other hand, argued that the borrower freely and voluntarily executed the loan agreement, with the benefit of independent legal advice, and without any coercion or undue influence. It was further argued that the interest rate reflected prevailing market rates at the time and that the borrower fully understood and accepted the terms of the agreement.

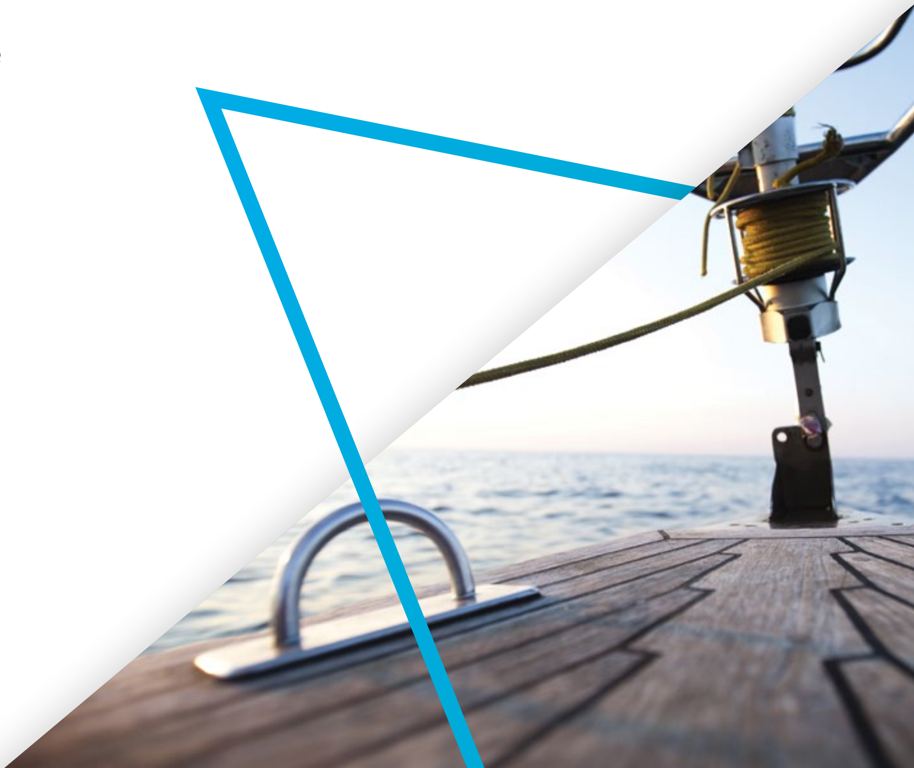
Findings

The trial court dismissed the borrower's argument, holding that he had agreed and willingly signed for the interest rate of 36% and that courts are not in the business of rewriting contracts simply because one party made a bad bargain. Dissatisfied with the judgment of the trial court, the borrower appealed against the judgment, and, on appeal, the Court clarified that although courts will not ordinarily interfere with freely negotiated contracts, they retain the power to refuse to enforce contracts or contractual terms that are unconscionable.

The Court devised a two-pronged test for determining unconscionability: procedural and substantive unconscionability. Procedural unconscionability considers whether the weaker party had a meaningful choice, examining elements such as undue pressure, deception or imbalance in bargaining power. Substantive unconscionability focuses on whether the actual terms of the contract are excessively harsh, unjust or overwhelmingly favour one party.

The Court emphasised that a measure of both procedural and substantive elements of unconscionability should be present before declaring a contract unconscionable.

The doctrine of unconscionability serves as a safeguard against agreements that are so one-sided or unfair that their enforcement would offend the principles of equity and justice. The Court stated that while courts do not intervene to rescue parties from regrettable bargains, they will refuse to enforce contracts that are unconscionable.



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Applying these principles, the Court found that the enforcement of the agreed interest rate would result in punitive or extortionate financial consequences to the borrower and held that the interest rate was unconscionable. Although the principal amount borrowed was KES 7 million and KES 3 million had been repaid, the compounded interest provisions would have ballooned the outstanding debt to over KES 69 billion. The Court noted that such a sum was excessive and that enforcing that term would be contrary to principles of fairness, good faith and proportionality.

Separately, the Court recognised that allowing the borrower to retain the unpaid balance of KES 4 million and to recover his property from the lender would result in unjust enrichment. Accordingly, it ordered the borrower to repay the KES 4 million balance with interest at court rates (12%) from the date of the High Court judgment and ordered the revocation of the lender's title to the borrower's property.

This decision reinforces the principle that although Kenyan courts will uphold contractual freedom, they will not enforce agreements that are unconscionable, particularly where they impose punitive financial consequences and undermine equitable principles.

Conclusion

While freedom of contract remains a cornerstone of commercial dealings, it is not absolute. Parties to contracts, particularly lending arrangements, should ensure that the terms of their agreements, specifically interest rates and compounding mechanisms are fair, proportionate, and commercially reasonable. Courts will not hesitate to declare loan agreements void if they contain oppressive or extortionate terms, especially where compounding over long periods leads to disproportionate escalation of debt. This decision affirms the court's willingness to protect weaker or disadvantaged parties to a transaction from exploitation and reinforces the importance of substantive fairness in commercial agreements.

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