LEGAL UPDATES

Late Charge Clauses at Risk When Assessed Against Unmatured Loans

The recent decision in Honchariw v. FJM Private Mortgage Fund, LLC, et al. raises serious doubts about the enforcement of very common late charge provisions

10/13/2022 | 2 minute read

Related Sectors

Financial Institutions

A typical late charge provision in promissory notes for commercial loans provides that when a borrower fails to make a monthly payment the lender may collect both (a) a one-time late charge equal to some percentage of the missed payment, and (b) an increased rate of interest (referred to as "default interest") on the entire outstanding balance of the loan. As discussed in a prior Hopkins & Carley creditors' rights client alert, when triggered by a maturity default, the default interest rate typically lasts until the default is cured or the loan is repaid.

A recent decision by the California First District Court of Appeal, however, declares that this common practice of collecting default interest may be unenforceable when assessed against an unmatured loan. The court in *Honchariw v. FJM Private Mortgage Fund, LLC, et al.* considered a default interest rate imposed under a provision just like the typical one described above. The borrowers failed to pay a monthly installment of a loan secured by real property. The promissory note called for a late charge of 10% of the unpaid monthly installment, and a default interest rate that increased the pre-default interest rate of the note by 9.99%, lasting until cure of the default or full repayment of the note.

The borrowers sought arbitration of their claim that the late charge was an unlawful penalty under Section 1671 of the California Civil Code, governing liquidated damages provisions such as the late charge provision. The arbitrator disagreed with the borrowers' argument, and denied the demand for arbitration. The borrowers then petitioned to vacate the arbitrator's decision, but lost again because the trial court concluded that the borrowers had failed to meet their burden of proof that the default interest provision constituted an invalid penalty.

The appellate court disagreed, however, reversing the trial court. After recognizing that liquidated damages provisions in non-consumer contracts are presumed valid, the Court of Appeal pointed out that the presumption can be overcome. The court explained that California public policy requires that liquidated damages must bear a "reasonable relationship" to the actual damages that the parties anticipate would flow from breach of an agreement. If the liquidated damages amount does not meet this standard, then it is an unenforceable penalty.

The court stated categorically that a default interest rate assessed against the entire unpaid balance of an unmatured loan did not represent a reasonable estimate of actual damages suffered by the lender because of the missed monthly payment. As a result, the court concluded that any such default interest rate constitutes an unlawful penalty.

This case raises serious doubts about the enforcement of very common late charge provisions, thereby limiting the utility of this powerful tool for encouraging borrowers to make their loan payments in a timely manner. In light of this case, lenders would be well advised to revisit the late charge provisions in their promissory notes. Our experienced team of creditors' rights attorneys have the knowledge and expertise to assist with this and all other loan documentation and enforcement issues.