Case Law Summary -- Default Interest and Late Charges

By John C. Murray

Introduction

Mortgage lenders customarily charge borrowers additional interest upon default, based on a percentage increase in the contract interest rate. In addition, they usually charge borrowers a fee for late payment of installments on the note, often based on a flat percentage of the payment if not made on the payment date or within a specified period of time thereafter. Federal and state case law is not consistent with respect to the issue of whether these charges and fees are enforceable, i.e., should they be enforceable only if they are justifiable based on the mortgagee's actual or anticipated costs — or should they be not be subjected to this, or any other, test as long as they are entered into by sophisticated parties?

Although late charges and default interest are generally upheld by both state and federal courts in connection with commercial mortgage-loan transactions and are entitled to a presumption of validity, they are occasionally disallowed in whole or in part under one or more of the following theories: 1) usurious additional interest; 2) invalid penalty; 3) unreasonableness; 4) unconscionability; and 5) unenforceable liquidated damages.

Unfortunately, the case law is conflicting and contradictory and fails to provide clear guidelines for the imposition and calculation of such charges and fees. As a result, this creates a certain amount of confusion and uncertainty. See, e.g., Crawforth v. Ajax Enterprises, LLC (In re Pheasant Cove, LLC), 2008 WL 187529 (Bankr. D. Idaho, Jan. 18, 2008), at *3 (describing “the lack of uniformity in the treatment of default interest provisions, which some courts evaluate under liquidated damages law and others under state usury laws”).

But the majority of courts realize that it is difficult for the lender to precisely calculate or quantify the exact costs incurred as a result of the borrower’s default, and they tend to look at what is common within the industry (especially in connection with commercial real-estate mortgage loans).

It is crucial that late-charge and default-interest provisions in mortgage-loan documents be carefully and comprehensively negotiated and drafted to reflect the true intention of the parties in order to avoid having to rely on a court to interpret ambiguous or incomplete language.

For a general discussion of cases on this topic, see Grant S. Nelson and Dale A. Whitman, Late Payment Charges and Default Interest – Judicial Interpretation, 1 REAL ESTATE FINANCE LAW § 6.9 (updated July 2010). See also
Baxter Dunaway, *Acceleration of Debt*, 2 L. DISTRESSED REAL EST. § 15:7 (updated June 2012) ("As a general rule, courts have upheld the right of the lender to accelerate in spite of borrowers’ arguments that acceleration acts as a penalty and despite a borrower’s good faith effort to avoid default").

With respect to the collection of default interest and other fees or charges in connection with mortgage loans where the borrower is in bankruptcy, Section 506(b) of the Bankruptcy Code provides that if a creditor is oversecured it may be allowed a claim against the bankruptcy estate only if the fee is reasonable -- which allows a bankruptcy court to disallow a late fee or default interest even if it is otherwise allowable under applicable state law. Also, in construing the lender’s claim for default interest if a bankruptcy proceeding is filed by or against the borrower, § 502 of the Bankruptcy Code generally allows a claim for pre-petition interest, including interest at the default rate if provided for in the parties’ agreement, in accordance with the terms of the contract. See *In re South Side House, LLC*, 451 B.R. 248, 264 (Bankr. E.D.N.Y. 2011) ("a creditor's agreement to prepetition interest under Section 502, default or otherwise, is determined in the first instance by the agreement between the parties and applicable nonbankruptcy law"); *Key Bank Nat'l Ass'n v. Milham (In re Milham)*, 141 F.3d 420, 423 (2d Cir.), cert denied 525 U.S. 872 (1998) ("[p]repetition interest is generally allowable [as a claim] to the extent and at the rate permitted under applicable noncontract law, including the law of contracts").

This article discusses and analyzes the following major state and federal cases in this area, up to and including August 31, 2012.

1. In *MetLife Capital Financial Corp. v. Washington Ave. Assocs.*, 313 N.J. Super. 525 (1998), the New Jersey Appellate Court, using a liquidated-damages analysis, ruled that a 5% late charge and a 15% default rate of interest contained in a mortgage note did not comply with the requirements of a valid liquidated-damages provision under New Jersey law. The court found that these charges were not reasonably related to the anticipated or actual damages incurred by the mortgagee, which the court held were capable of exact determination and were therefore not unascertainable or difficult to prove. The court also rejected the argument by the mortgagee that such charges were “customary” or “industry standard.” Instead, the court required the mortgagee to prove that actual losses were incurred and the exact amount of such losses. The court found that the testimony of the mortgagee’s officers was insufficient in this regard. *But see MetLife Capital Fin. Corp. v. Washington Ave. Assocs.*, 159 N.J. 484 (N.J. 1999) (quoting Restatement (Second) of Contracts § 356 (1981)), and holding that New Jersey courts have included in their definition of liquidated damages fixed percentage late fees, default provisions that provide for an increase in loan contract interest rates (“default interest provisions”), and provisions in loan contracts that permit a prepayment premium).
2. But in MetLife Capital Financial Corp. v. Washington Avenue Associates, 159 N.J. 484 (1999), the New Jersey Supreme Court reversed the decision of the appellate court, which had held that MetLife's imposition of a late charge of 5% of the delinquent payment, as well as a default interest rate at "the greater of five percent (5%) per annum in excess of the 'prime rate' . . . from time to time, or fifteen percent (15%) per annum," were unenforceable penalties under a liquidated damages analysis. (MetLife had not appealed the appellate court's reduction of the default interest rate to 12.55%, which was 3% greater than the non-default contract interest rate).

The New Jersey Supreme Court first addressed the issue of the reasonableness of the late charge. The court reviewed the history and development of stipulated damages provisions, including case law and the UCC provision on liquidated damages, and concluded that "'reasonableness' emerges as the standard for deciding the validity of stipulated damages clauses." Utilizing the "reasonableness" test, the court held that the five percent late charge was a valid measure of liquidated damages. The court explicitly disagreed with the finding of the appellate court that damages arising from a late payment with respect to a larger loan would not result in a greater administrative or "opportunity cost" risk to the lender, or require greater oversight and supervision. The court also noted that it would be impractical to require the lender to calculate its exact damages with respect to a specific defaulted loan, because the lender's costs are spread over its entire portfolio of loans.

It would be more realistic, the court found, to examine the statutory treatment of late charges as well as common and accepted practice in the industry. Under this standard, the court ruled that the reasonableness of the charge had been successfully demonstrated based on the following factors: the uncontradicted testimony of MetLife's representative that the charge was customary in connection with commercial mortgage loans and fairly compensated the lender for the administrative costs involved in connection with servicing delinquent loans; the express authorization, under both New Jersey statutes and numerous federal statutes and regulations governing various classes of mortgage lenders, of late charges of five percent; case law from other jurisdictions generally upholding fixed percentage late charges negotiated between sophisticated commercial entities, which were within the "industry standard" range; the "suggestion" of case law from New Jersey and other jurisdictions that a small percentage late charge was simply a normal part of the cost of doing business; and the failure to demonstrate any evidence of fraud, duress or other unconscionable acts on the part of MetLife.
The court then turned to the issue of the reasonableness of the default interest rate. Consistent with its holding on late fees, the court noted that, "[d]efault interest rates, like late fees, are presumed reasonable." \textit{Id.}, 159 N.J. at 501. The court's review of New Jersey case law in this area revealed that a default interest rate would be invalidated as a penalty if "the[] size suggests a punitive intent." \textit{Id.}

Because the interest rate increase in this case was only three percent, the court found it to be "a reasonable estimate of the potential costs of administering a defaulted loan, and the potential difference between the contract rate and the rate that MetLife might pay to secure a commercial loan replacing the lost funds." \textit{Id.}, 159 N.J. at 501. The court noted the difficulties faced by lenders in determining actual losses resulting from a commercial loan default; in predicting the nature and term of a loan default or market conditions for commercial loans in the future; in predicting their economic losses and what might ultimately be recovered from a foreclosure sale; in determining what their own borrowing costs might be in the future; and in estimating their collection costs.

Based on existing case law and standard mortgage practice that has existed for quite some time, the appellate court's holding in the MetLife case truly appeared to be an aberration - one that the New Jersey Supreme Court has now rectified. As the court noted, it has adopted the "modern trend" that permits more flexibility when analyzing the reasonableness of late charges and default interest rates in commercial loan documents.

The court appeared to be moving toward a "consenting adults" approach, under which almost anything goes when sophisticated parties, represented by counsel, are involved in negotiating complex commercial real estate financing transactions -- as long as the fees and charges imposed are within industry-standard norms and ranges and don't appear to be clearly "unconscionable."

At the end of its opinion the court acknowledged that the imposition of late charges and default interest rates is a "practical solution to the problem of pricing loans according to anticipated rather than actual performance and the difficulty in allocation and determining the costs and damages of late payments and default," and agreed that "[t]he alternatives are economically inefficient or judicially impracticable." Interestingly, however, the court rejected MetLife's argument that late charges and default interest rates should be analyzed strictly in accordance with contract law principles, and should not be subjected to a liquidated damages analysis because of the "fiercely competitive marketplace" and the difficulty of calculating actual damages.
Although agreeing with MetLife that the imposition of such charges is a legitimate cost of doing business, the court was not prepared to go as far as to incorporate such a factor into the "reasonableness" test. Rather, the court stated its belief that courts are "accustomed to dealing with the standard of reasonableness," and that it would continue to evaluate late charges and default interest rates under this standard, instead of employing an "unconscionability" test. According to the court, the continued use of the "reasonableness" standard would "provide[] an adequate safeguard for the lenders and better protection for the borrowers."

See Foreclosure: New Jersey High Court Upholds Late Charges, 29-OCT REAL EST. L. REP. 8 (1999), which summarized the New Jersey Supreme Court's holding in MetLife as follows:

The court noted that a 5% late fee was "normal industry custom in similar commercial mortgages." In addition, the loan was an arm's-length transaction between sophisticated parties, both represented by counsel. The interest default rate was a reasonable estimate, said the court, of the potential costs of administering a defaulted loan.

3. In Norwest Bank Minnesota v. Blair Road Associates, L.P., 252 F.Supp.2d 86, 94 (D.N.J. 2003) the court agreed with the holding of the New Jersey Supreme Court in MetLife, and held that the default interest rate could exceed 3% over the contract rate (the increase considered reasonable in MetLife). The court stated that "it is important to note that a default interest rate provision is presumptively reasonable and it is the defendants who have the burden of proving its unreasonableness." Id. at 92.

4. See also 1095 Commonwealth Ave. Corp., 204 B.R. 284, 304-05 (Bankr. D. Mass. 1997) (allowing recovery at default rate of interest but precluding recovery of late fees because "[b]oth the late charge and the default rate of interest are intended to compensate the lender for the increased costs of administration caused by the borrower's failure to make the payment as and when it is due"); In re Vest Assocs., 217 B.R. 696, 701 (Bankr. S.D.N.Y. 1998) ("oversecured creditors may receive payment of either default interest or late charges, but not both"); In re Udhus, 218 B.R. 513, 517 (9th Cir. B.A.P. 1998) (holding that cure pursuant to an approved Chapter 11 plan of reorganization prevents application of default interest; court stated that "since the loss of opportunity costs is the same as the loss of default interest, it would be unreasonable to include this part of the claim as an allowable administrative expense"); In re Hollstrom, 133 B.R. 535, 539-40 (Bankr. D. Colo. 1991) (ruling that a 36% rate of interest would be deemed a penalty where the non-default rate was 14% and there was no evidence presented to justify application of the default rate);
In re White, 88 B.R. 498, 511 (Bankr. D. Mass. 1988) (finding that a 48% default rate of interest was unreasonable, and therefore a penalty, where the non-default rate was 16.5% and grossly disproportionate to the damages resulting from the breach); In re Boardwalk Partners, 171 B.R. 87, 92-93 (Bankr. D. Ariz. 1994) (holding that a 25% default rate of interest, which constituted a 14.5% spread over the non-default rate, was a penalty); In re DWS Investments, Inc., 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990) (25% default interest rate deemed a penalty); Fischer Enterprises, Inc. v. Geremia (In re Kalian), 178 B.R. 308, 309 (Bankr. D. R.I. 1995) (holding that a spread of 18% between the default rate and the non-default rate constituted a penalty); In re Boulders on the River, Inc., 169 B.R. 969, 975 (Bankr. D. Or. 1994) (disallowing a claim for default interest at a rate 5% higher than the contract rate because the court was not "persuaded that the default rate of interest constitutes anything but a mere penalty"); Key Bank Nat'l Ass'n v. Milham (In re Milham), 141 F.3d. 420, 423 (2nd Cir. 1998), cert. denied, 119 S. Ct. 169 (1998) ("Most courts have awarded penalty interest at the contractual rate; but nevertheless, however widespread the practice may be, it does not reflect an entitlement to interest at the contractual rate"); Bradford v. Crozier (In re Laymon), 958 F.2d 72, 75 (5th Cir. 1992), cert. denied, 506 U.S. 917, 113 S. Ct. 328 (1992) (holding that the "rate of interest [chargeable under § 506(b)] should be determined 'by examining the equities involved in the bankruptcy proceeding'). Cf. Crawforth v. Ajax Enterprises, LLC (In re Pheasant Cove, LLC), supra, 2008 WL 187529 at *7 (holding that default rate and late charges of approximately $300,000 were not unreasonable or a penalty in connection with multi-million dollar loan and distinguishing In re White, supra).

5. In MONY Life Ins. Co. v. Paramus Parkway Bldg., Ltd., 364 N.J. Super. 92, N.J., Super. Ct. App. Div. 2003), the New Jersey appellate court (affirming prior New Jersey rulings) ruled that certain lender charges in commercial mortgage transactions that constitute (in the court's view) liquidated damages, such as late fees, default interest rates, and prepayment premiums are subject to the test of "reasonableness" and are not subject to an unconscionability standard where the parties to the transaction are sophisticated and experienced, and that the borrower could not challenge the default interest rate, prepayment premium, or other contractual penalties negotiated as part of a loan workout with the lender. (Although the court mentions late fees in the preamble to the opinion, there is no discussion of late fees elsewhere.)

The defendant borrowed $6.9 million from the lender and executed a mortgage for this amount on the debtor's warehouse and office facility. Later, after various defaults by the borrower, the parties entered into a mortgage modification agreement that extended the maturity date, provided for a default rate of six percent over the contract rate of nine
percent, and added a prepayment charge of three percent of the principal amount commencing on November 1, 1995, declining one half of one percent per year.

The borrower again defaulted, and the lender filed a state foreclosure action. The borrower then filed various (and basically bogus!) defenses, alleging that the note and mortgage were void due to "Illegal and unconscionable penalties contained therein." A receiver was appointed who, after initial failure to cooperate by the borrower, began collecting the rental income. A final judgment of foreclosure was entered, which included interest at the default rate and the prepayment charge as set forth in the modification agreement. Before the sheriff's sale, the borrower found a purchaser for the property (for an amount over $2.5 million more than what was owed on the mortgage!) and paid off the mortgage "under protest and without waiver of any of [its] rights and/or remedies." The lender then dismissed the foreclosure action and the sale was closed. Subsequently, the lender revised its payoff figure downward and refunded approximately $93,500 to the borrower, stating that the check for this amount was being tendered "with a complete reservation of [the lender's] rights and remedies and a waiver of none." The borrower returned the check, claiming that it had overpaid by an amount greatly in excess of the amount tendered, and reserving all of its rights and remedies.

The borrower then appealed the judgment of foreclosure, arguing that the lender's motion for final judgment should not have been granted because the borrower had contested the amount that was claimed to be due and owing and had not had a chance to complete discovery of the issue of whether such amounts were reasonable. In particular, the borrower asserted that (1) the principal indebtedness had not been properly calculated, (2) the 6% default interest rate was "a penalty and unenforceable," (3) the prepayment premium was "illegal," (4) the interest on the debt had been miscalculated, and (5) the amount of attorney's fees demanded was excessive.

The court first ruled that the fact that the borrower had paid off the mortgage did not extinguish its right to challenge the foreclosure judgment. The court then made short shrift of the borrower's other arguments, deeming "these remaining issues to be without merit." The court noted that the borrower had not produced any evidence that the amounts owing under the loan documents were not correct nor had it challenged the principal amount claimed to be due, or alleged fraud, duress or any other unconscionable acts. The court also noted that the lender had discovered and acknowledged an overpayment by the borrower and refunded the balance owing to the borrower.
The court then dismissed the borrower's arguments regarding accrued interest, default interest, and the prepayment premium "for the same reason, "i.e., that such arguments were neither factually nor legally supported by the record. The court stated that in New Jersey, "liquidated damages, such as late fees, default interest rates, and prepayment premiums are subject to the test of reasonableness, that is, whether the stipulated damage clause is reasonable under the circumstances," citing the New Jersey Supreme Court's holding in MetLife v. Washington Avenue Associates, L.P., supra, (upholding as reasonable a late fee of five percent and default rate of 12.55%) and Westmark Commercial Mortgage Fund IV v. Teen form Associates, L.P., 362 N.J. Super. 336, 341-42 (App. Div. 2003) (evaluating default rate in commercial contract using reasonableness standard, and determining that late fee of six percent -- as opposed to five percent in MetLife -- and default rate of two percent in excess of contract rate were reasonable in absence of any evidence to contrary).

The court concurred with the conclusions of the courts in these cases, i.e., that various forms of special charges on default are customary and justified in commercial loan transactions between sophisticated parties represented by counsel, and are "presumptively reasonable" in such circumstances, shifting the burden of proving unreasonableness to the borrower. (Amazingly, the court notes in a footnote that "the general partner in Washington Avenue Associates, the defendant in MetLife, was Laurence S. Berger, who is also a principal of [the borrower] in this case," and was described by the judge in a prior decision as "a practicing attorney [who had] demonstrated a very high degree of sophistication in the area of mortgage lending." Id. at 103 n. 3). The court also noted that "[t]he certainty of the remedy provided by the clause undoubtedly affected the pricing of the loan," especially where, as in this case, there had been a pattern of prior defaults. Id. at 104.

6. In In re Route One West Windsor Limited Partnership, 225 B.R. 76 (Bankr. D.N.J. 1998), the court, applying New York law (the parties had stipulated New York law would apply in a choice-of-law provision in the loan agreement), held that a provision in the debtor's mortgage-loan agreement with an oversecured creditor to pay interest following default at the post-default rate of 15.125% was not an unenforceable penalty and must be paid by the debtor. The court found that the increased default rate of interest was justifiable and reasonable because it merely compensated the mortgagee for the increased risk and expense of collection. The court also held that the allowance of default interest on a claim in bankruptcy is determined by federal law, but noted that state law would be relevant because if the amount exceeded the allowable legal rate, then the bankruptcy court would not permit the mortgagee to recover such a windfall amount in a bankruptcy proceeding. The court also noted that the
principal of the debtor was a sophisticated businessman who had knowingly and freely allowed the debtor partnership to contract for the post-default interest rate. The court further found that no other non-insider creditors of the debtor would bear the adverse effects of the increased rate of interest paid to the mortgagee. The court, citing *MetLife Capital*, *supra*, noted that, “under New Jersey law default interest rates that are penalties are unenforceable.” *Id.* at 88. The court distinguished *MetLife Capital*, stating that, “There is no question that default interest is generally permitted under New York law and is difficult to obtain under New Jersey law. Under New Jersey law a liquidated damages clause is only valid if (1) the amount fixed is related to the actual damage that is likely to be suffered, and (2) the amount of the damage caused by the breach is of the type which is incapable or very difficult to actually estimate.” *Id.* at 99, fn.2. The bankruptcy court also noted that under New York law default interest rates as high as 25% had been consistently held to be reasonable. However, the court held that the mortgagee would not be permitted to receive both interest at the post-default rate and late charges. The court therefore upheld the enforceability of the default-interest provision but not the provision for the payment of late charges by the debtor. Finally, the court also ruled that the mortgagee would not be permitted to receive interest on the default interest that accrued post-petition. The court noted in support of this specific holding that the loan documents did not provide for the payment of such interest-on-interest and that the allowance of such additional amounts would not be equitable.

7. In a similar decision, *In re Dixon*, 228 B.R. 166, 174-77 (Bankr. W.D. Va. 1998), the court held that although the default interest rate of 36% (double the pre-default rate) was high, it would accept the creditor’s representation -- without requiring testimony or evidence -- that the default rate was proportionate to the reasonably anticipated damage from default and was not a penalty. The court stated that it did not have the “power to alter commercial contracts or to substitute [its] judgment for that of the parties” where the transaction was lawful, no other creditors were harmed, the default rate did not violate state usury laws, and there was no threat to the reorganization of the debtor by imposition of the default rate, and that “whether interest will be allowed at the default rate is determined on a case-by-case basis and is fact specific.” *Id.* at 174. The court, citing *In re Terry Ltd., Partnership*, 27 F.3d 241, 244 (7th Cir. 1994), *cert denied sub nom Invex Holdings, N.V. v. Equitable Life Ins. Co. of Iowa*, 513 U.S. 948, 115 S. Ct. 360 (1994) and *In re Consolidated Properties Ltd. Partnership*, 152 B.R. 452, 457 (Bankr. D.Md. 1993), also stated that “[d]efault interest rates are also necessarily higher than basic interest rates in order to compensate creditors for both the predictable and unpredictable costs of monitoring the value of collateral in default situations.” However, the court noted that “[e]ven when the late charge is reasonable . . . a creditor may be denied recovery where it also asserts a claim to a default rate of
interest”). Id. at 172. See also In re AE Hotel Venture, 321 B.R. 209 (Bankr. N.D. Ill. 2005) (ruling that, under Illinois law, lender could not collect default interest in addition to late fee unless it could prove that collection of late fee was insufficient to compensate it for its actual damages); In re Wines, 239 B.R. 703, 709 (Bankr. D.N.J., 1999) (citing New Jersey Supreme Court’s holding in MetLife, supra, and stating that “[a]lthough that decision does not apply to residential mortgages, courts have traditionally allowed late charges according to the contract of the parties”).

a. See also In re Venderveer Estates Holdings, Inc., 283 B.R. at 134 (“Both the default interest rate of 12.56% [the non-default rate was 7.56%] and the differential of 5% between the default and non-default rates, are well within the range of default rates that would have been allowed as reasonable charges under § 506(b)”; In re Southland Corp., 160 F.3d 1054, 1060 (5th Cir. 1998) (holding that recovery by the debtor of the contractual postpetition default rate was not inequitable where the 2% spread between the default and non-default rate was “relatively small,” the mortgagee was “not obstructing the [bankruptcy] process,” and no junior creditors would be harmed if the mortgagee was awarded default interest); In re Liberty Warehouse Assoc. Ltd. Partnership, 220 B.R 546, 551-52 (S.D.N.Y. 1998) (stating that “[the mortgagee] is entitled to accrue pendency interest on its claim because it is oversecured” and finding that the default rate of 22.8% was reasonable and not a “disguised penalty,” where the non-default rate was 14%; the court, citing In re Ace-Texas, Inc., 217 B.R. 719,721 (Bankr. D. Del. 1998), also held that where the underlying debt has matured by its own terms, there is nothing for the mortgagor to reinstate and any attempt by the mortgagor to “cure” the default and reinstate the original terms would constitute an impairment of the mortgagee’s right to immediate payment); Bruce v. Martin, 845 F.Supp. 146 (S.D.N.Y. 1994) (ruling that a default rate of 24.9% was allowable under New York Penal Law and was not usurious); In re Terry Ltd. Partnership, 27 F.3d 241, 243 (9th Cir. 1994) (finding that there is “a presumption in favor of the contract rate subject to rebuttal based on equitable considerations”); Greenwood Trust Co. v. Commonwealth of Massachusetts, 971 F.2d 818, 825 (1st Cir. 1992) (holding that late charges are a form of interest, and that the State of Massachusetts could not bar an out-of-state bank from charging late-payment fees on delinquent credit-card accounts, and stating that “federal case law has long suggested that, in ordinary usage, interest may encompass late fees and kindred charges”); Holmes v. Citigroup Investments Agrifinance (In re Holmes), 330 B.R. 317, 321 (Bankr. M.D. Ga. 2005) (“courts should be reluctant to infer a mechanism for disallowing default rates of interest under
federal law. Rather, the allowability of the rate should turn instead on applicable nonbankruptcy law”); *Orix Credit Alliance CIT Group/Equipment Financing, Inc. (In re Hughes)*, 230 B.R. 213, 230 (Bankr. M.D. Ga. 1998) (holding that when creditor is oversecured, estate need not be solvent for creditor to be entitled to postpetition interest); *In re Richardson*, 63 B.R. 112, 113 (Bankr. W.D. Va. 1986) (holding that oversecured creditor could recover late charges); *Mack Financial Corp. v. Ireson*, 53 B.R 118, 120 (Bankr. W.D. Va. 1985) (holding that creditor can obtain late charges if creditor is oversecured and charges are reasonable).

b. In *In re 139-141 Owners Corp.*, 306 B.R. 763 (Bankr. LEXIS 83 (Bankr. S.D.N.Y. 2004), the bankruptcy court, citing prior authority in the Second Circuit (and in other jurisdictions), ruled that while in most circumstances it is within the court’s equitable power to limit or prevent the collection of the contractual default rate by the mortgagee in order to provide an “equitable distribution” to creditors, this is not a statutory right and is inappropriate and inequitable, and therefore should not be invoked, where the debtor is solvent and the rights of unsecured creditors are not adversely affected. The bankruptcy court cited the Second Circuit’s prior ruling in *Ruskin v. Griffiths*, 269 F.2d 827 (2nd Cir. 1959), *cert. denied*, 361 U.S. 947 (1960) which enforced the creditor’s right to the contractual default interest rate where the debtor was solvent. The court in *139-141 Owners Corp.* stated that, “Ruskin remains effective to date in the Second Circuit and is recognized by other circuits,” Id. at 771, and cited numerous decisions upholding the creditor’s right to contractual default interest where there were no countervailing equitable considerations. The court found that in this case the equities did not warrant the exercise of the court’s equitable discretion to nullify the creditor’s contractual right to collect default interest, for the following reasons: the debtor was solvent at all times, (the value of the debtor’s assets was more than twice its liabilities); its income was more than sufficient to pay its obligations as they became due, including debt service on both the first mortgage and second mortgage in effect on the property; the debtor defaulted in the payment of both mortgages for the sole purpose of diverting income to pay for the debtor’s other business ventures; the debtor did not file its bankruptcy proceeding to become profitable, to protect other creditors, or to prevent a foreclosure sale that would wipe out equity in the property; and any prohibition of the creditor’s right to collect interest at the stated default rate would be of sole benefit to the debtor and would create an unwarranted windfall.
c. See generally 4 A. Resnick and H. Sommer, COLLIER ON BANKRUPTCY P 506.04[2][b][ii] at 506-112 (15th rev. ed. 2004 (“in general a default rate of interest is properly a form of interest”); Melanie Rovner Cohen, Jeff J. Marwell, Richard A. Gerard, Entitlement of Secured Creditors to Default Interest Rates Under Bankruptcy Code Sections 506(b) and 1124, 45 BUS. LAW. 415 (1989); Annot., Validity and Construction of Provision Imposing “Late Charge” or Similar Exaction for Delay in Making Periodic Payments on Note, Mortgage, or Installment Sale Contract, 63 A.L.R. 3D, § 5 (1975); Harris Ominsky and Stuart D. Poppel, Loans: Late Charges Challenged, 116 BANKING L.J. 4 (1999); Annot., Grounds of Relief from Acceleration Clause in Mortgage, 70 A.L.R. 993 (1931); Michael T. Madison, Jeffry R. Dwyer, and Steven W. Bender, The Mortgage/Deed of Trust – Events of Default and Charges Upon Default – Late Payment Charges and Default Interest, 1 LAW OF REAL ESTATE FINANCING § 5:106 (updated July 2012) (“In scrutinizing the fairness of the late payment charge under state law, courts tend to apply the liquidated damages standard of reasonableness rather than the more lax standard of exorbitance employed under the common law doctrine of unconscionability”); John C. Murray, Default Interest Rates, Late Charges, and Exit Fees: Are They Enforceable? SM002 ALI-ABA 2679 (2006) (discussing various types of fees and charges imposed by mortgage lenders in loan documents and whether courts find them enforceable, including default-interest and late-charge provisions, late charges, and exit fees.)

8. Under Illinois law, a late charge provided for in the note evidencing a mortgage loan may be deemed to be an unenforceable penalty. See Garcia v. Canan, 851 F.Supp. 327, 328-29 (N.D. Ill. 1994) (holding that late charge based on 10 percent of unpaid installments, regardless of how many days borrower was delinquent, was penalty and not liquidated damages; lender did not seek recovery of late charge until loan had been accelerated); AT&T Capital Leasing Services, Inc. v. Brasch, 912 F.Supp. 395, 397 (N.D. Ill. 1996) (upholding defendant’s claim that, under Illinois law, 10% late penalty was unenforceable penalty and stating that Illinois “imposes that prohibition as a matter of public policy, which overrides any possible entitlement to such penalties derived from any other source”); Heath v. Y.S. Mortg., LLC, 2006 WL 488642 (S.D. Ill., 2006), at *5 (“Under Illinois law, in the situation now before the Court, a cost-of-money provision not dependent on the length of delay of repayment -- one that is simply a flat percentage levy -- cannot escape the ‘penalty’ label”). Cf. Whirlpool Financial Corp. v. Sevaux, 96 F.3d 216, 227 (C.A.7 (Ill.), 1996), in which the court noted that in Illinois, the Interest Act, 815 ILCS 205/7, requires a
party intending to rely upon a usury defense or claim to provide adequate notice to the court and to the opposing party, and that the Interest Act was applicable in Federal court also. The court found that the borrower was put on sufficient notice of the possibility of a usury defense because the lender’s complaint sought full recovery of the debt according to the terms of the loan documents, including a five-percent late charge and as well as simple interest of two percent over prime. The court ruled that the borrower thereby waived the usury defense, including the late charge, by failing to raise the defense of usury in a timely manner despite numerous opportunities to do so.

9. Some courts look closely at the adequacy and sufficiency of the language in the loan documents to determine whether default interest is due on the loan, especially in connection with loans that remain unpaid at maturity. This determination is often crucial and clearly emphasizes the need for precise and accurate drafting of default and acceleration clauses in mortgage-loan documents.

a. See, e.g., *In re Crystal Properties, Ltd.*, 268 F.3d 743 (9th Cir. 2001). In this case, the court found that under the default language in the loan documents the lender could not collect default interest until it had actually accelerated the debt. The court held that the lender had never formally accelerated the loan by notice to the borrower, regardless of the fact that the applicable default provision stated that the borrower waived notice of demand or default. (The borrower filed a Chapter 11 bankruptcy case after the loan had not been paid at maturity.) The court further held that the maturity date of the loan did not constitute an automatic acceleration, and that under the language in the default clause only an acceleration of the entire loan would trigger default interest. The court therefore upheld the bankruptcy court and district court opinions disallowing the bank’s claim in its entirety.

b. See generally Joshua Stein, *How Some “Standard” Language in a Promissory Note Cost a Lender Five Years of Default-Rate Interest Rate*, Groundbreakers, 18 No. 4 PRAC. REAL EST. LAW. 60 (July 2002) (discussing and analyzing the *Crystal Properties* case, and providing excellent drafting tips to minimize the risk of improper or insufficient acceleration and notice); John C. Murray, supra, *Default Interest Rates, Late Charges, and Exit Fees: Are They Enforceable?*, at pp. 10-11 (discussing cases dealing with late charge imposed by lender after acceleration of debt.)
c. See also U.S v. Neudai, Inc., 14 F.3d 598 (4th Cir. 1993), 1993 WL 537722 (C.A.4 (S.C.)), at *3 (unpublished). The court’s holding in this case is virtually identical to that of Crystal Properties, supra; i.e., the terms of the loan documents at issue dealt with acceleration of the debt, and there was no separate provision for charging default interest. The Fourth Circuit noted that “courts usually require that an acceleration be exercised in a manner so clear and unequivocal that it leaves no doubt that the borrower is apprised that the option has been exercised” (internal citation and quotations omitted). See also In re Zamani, 390 B.R. 680, 689 (Bankr. N.D. Cal. 2008) (“The record before me, as in Crystal Properties, fails to establish that . . . the bank clearly and unequivocally notified [the borrower] that it was exercising its right to accelerate the notes”).

d. Similarly, in JCC Development Corp. v. Levy, 146 Cal.Rptr.3d 635 (Cal App. 2 Dist., 2012), the court agreed with the holding in Crystal Properties, supra, and held that based on the language in the loan documents, the lender could not collect interest on the matured loan at the default interest rate because the default rate provision was part of an acceleration clause that was not triggered before the note matured. According to the court:

The plain language of the note states that once one of the circumstances occurred which would accelerate the loan, “thereafter” interest could accrue at the maximum legal rate. The default interest language appears in the same paragraph as the acceleration clause and there is no indication in the note that this language relates to circumstances other than acceleration (e.g., failure to pay the lump-sum payment at the time the loan matured). Levy, the drafter of the agreement, could have included language stating that the default interest rate applied not only after circumstances of acceleration, but also after the loan matured and no payment was made, but he did not include such additional language.
Id. at 643.

For commentary on this decision, see Prof. Dan Schechter, *Where Debt Was Never Accelerated and Promissory Note Conditioned Default Interest on Acceleration, Default Interest Cannot Be Charged*. [JCC Development Corp. vs. Levy (Cal. App. 2012).], 2012 COMM. FIN. NEWS. (2012). The author, noting that the court in *JCC Development Corp.* relied on the Ninth Circuit’s holding in *Crystal Properties*, supra, stated that:

The [JCC Development Corp.] opinion lays out the simple drafting lesson: don't make default interest contingent upon formal acceleration. Make it automatic. *Crystal Properties* was decided more than 10 years ago; any deal booked after 2001 should have incorporated the lessons of *Crystal*; and yet we often see antiquated language in recently drafted documents. It might be a good idea for lenders' counsel to conduct periodic reviews of the form files, to make sure that the forms contain the “latest and greatest” provisions.

e. In *United States v. Cardinal*, 452 F.Supp. 542 (D.Vt. 1978), the court noted as follows:

The law is well settled that where the acceleration of the installment payments in cases of default is optional on the part of the holder, then the entire debt does not become due on the mere default of payment but affirmative action by the creditor must be taken to make it known to the debtor that he has exercised his option to accelerate, even though the note itself, as is the case here, waives notice of demand.

Id. at 547 (quoting *Moresi v. Far West Services, Inc.*, 291 F.Supp 586, 588 (D.Hawaii 1968)).

f. See also *In re Payless Cashways, Inc.*, 287 B.R. 482, 485 (Bankr. W.D.Mo. 2002), where the court stated that the same rule regarding acceleration of the debt applied in the Eighth Circuit as was applicable in the Ninth Circuit:
The court in *Beal Bank v. Crystal Properties, Ltd.*, held that under both California law and the law of the Ninth Circuit, even if the terms of a note do not require notice or demand as a prerequisite to accelerating a note, the holder must take affirmative action to notify the debtor if it intends to accelerate. This is certainly true in the Eighth Circuit.

With respect to the court’s holding in *Payless Cashways*, at least one commentator strongly disagrees with the court’s decision, as well as the Ninth Circuit’s decision in *Crystal Properties*, supra. See Prof. Dan Schechter, *Oversecured Creditor Is Not Entitled to “Default Interest” Without Prior Notice to Debtor of Acceleration*, 2003 COMM. FIN. NEWS.7 (January 20, 2003). The author states that, with respect to the bankruptcy court’s holding in *Payless Cashways*:

The Ninth Circuit’s decision in *Crystal* was wrong, and this one [the *Payless Cashways* decision] is “wronger.” At least the Ninth Circuit tried to justify its result on the basis of California law, although California law does not clearly say that default interest cannot be triggered without notice when the contract provides for an automatic trigger. The Ninth Circuit’s decision on this issue was also probably dicta, since the contract at issue in that case did not provide for default interest without notice of acceleration. Finally, the Ninth Circuit failed to distinguish between the triggering of the default rate and acceleration of the entire loan. Those two issues are not necessarily linked, although they often are linked in practice.

Here, however [in the *Payless Cashways* case], the court adopted the flawed rule in *Crystal* as if it were a Federal rule, which it is not. Also, the sweeping scope of the court’s decision is unjustified, since the contract itself said that the default rate would apply only to the missed payment. The court had no reason to promulgate a rule of general application to all credit agreements, to the effect that there
can be no default rate applied to the entire balance in the absence of notice of acceleration.

g. But see Greystone Bank v. Skyline Woods Realty, LLC, 817 F. Supp. 2d 57, 62-63 (2011) (holding that when mortgage documents do not require notice of default and acceleration and provide that upon default lender may declare the entire debt due and owing, no notice is required and the “filing of a summons and complaint is sufficient notice of intent to accelerate”); In re South Side House, LLC, 451 B.R. 248, 266 (Bankr. E.D.N.Y. 2011) (bankruptcy court held default charge fully enforceable from date of default without notice to debtor, and stated that “As the Loan Documents provide that the default interest becomes due upon default, without notice to the Debtor, the default interest was due whether or not the Lender accelerated the Loan.”)

h. Courts generally will not allow a loan holder that is an assignee of the original loan holder to charge default interest if the original loan holder previously elected not to do so. For example, in In re Sweet, 369 B.R. 644, 651 (Bankr. D. Colo. 2007), the note stated that “in the event of a default, the terms of the Note specifically provide the Note holder may in its discretion determine all amounts due and owing . . .” The assignee of the note argued that this language allowed it to retroactively apply the default rate of interest from the time the debtor ceased making payments on the note even though the assignee was not the holder of the note when the default occurred. The court rejected this argument, stating that “the original loan holder had never expressed any intent to charge default interest,” and that the assignee of the note could not “retroactively substitute his discretion for that of [the original lender] in order to apply default interest to the [notice] when [the lender] first noted a default in the Note.” Id. at 651.

See also In re Lichtin/Wade, LLC, 2012 WL 3260287 (Bankr. E.D. N.C., Aug. 8, 2012), at *5, where the court stated that “because the original loan holder . . . did not express an intent to charge default interest on the date of maturity, the assignee . . . cannot retroactively substitute its judgment for that of [the original loan holder]”; In re Crystal Properties, Ltd., LP, supra, 268 F.3d at 747 (finding it inequitable to allow present loan holder to recalculate interest for period
when predecessor did not and considering the right to have been waived); *Harvest Oaks Drive Assoc., LLC*, 2011 WL 124495, at *11 (Bankr. E.D.N.C. Jan. 14, 2011) (following *Crystal Properties* in disallowing retroactive imposition of charges not claimed by prior holder); *In re 400 Walnut Associates, L.P.*, 461 B.R. 308, 314 (Bankr. E.D. Pa. 2011) (holding that waiver by mortgagee’s predecessor of its contractual right to compound interest during time period when it held loan prevented assignee from retroactively compounding unpaid interest for that period of time).

i. *But see In re Deep River Warehouse*, 2005 W.L. 1513123 (Bankr. M.D.N.C., June 22, 2005), at *4, in which the court allowed the full default acceleration rate to the lender, and distinguished *Crystal Properties* as follows:

The reasoning behind the court’s refusal to allow interest at the default rate in *Crystal Properties* was not because the lender did not give notice of the default; it was because the lender did not perform the affirmative act of putting the debtor on notice that it intended to accelerate the debt. *Id.* at 749 (holding that courts have made clear the unquestionable principal that, even if the terms of the note do not require notice as a prerequisite to acceleration, the holder must take affirmative action to notify the debtor that it intends to accelerate). The Debtor’s reliance on *Crystal Properties* is misplaced inasmuch as *Crystal Properties* did not hold that notice must be given before default interest can be charged against a debtor.

The court in *Deep River Warehouse* determined that the following factors should be examined to determine whether a specific default-interest provision should be enforced:

1. the creditor faces a significant risk that the debt will be paid;

2. the lower rate of interest payable pre-default is shown not to be the prevailing market rate;

3. the difference between the default and the pre-default rates, and whether the differential between the two rates are reasonable; and
(4) whether the purpose of the higher interest rate is to compensate the creditor entitled to interest for losses sustained as a result of the fact that it was not paid at maturity or is simply a disguised attempt to penalize the debtor. *Id.* at *3-4.

The court noted that it must “read the terms of the Loan Documents in context, giving each term its plain meaning.” *Id.* at *5.

See also *In re Croatan Surf Club, Inc.*, 2012 WL 1906386 (Bankr. E.D.N.C., May 25, 2012) In this case the court held that based on the factors considered by the bankruptcy court in *Deep River Warehouse, supra*, the default rate in question was within the range of reasonableness, “primarily because the difference between the default and pre-default rates is a mere 3% and therefore does not appear to be intended as a penalty.” *Id.* at *4.

j. In *In re Harvest Oaks Associates, LLC, supra*, 2011 WL 124495, the court examined the facts of the case and the specific language set forth in both the promissory note and the deed of trust, stating that it “must first look to the language of the relevant loan documents.” *Id.* at *6. The court held that “In this case, with respect to the payment default, there are insufficient grounds on which to deviate from the terms set out in the parties' agreement.” *Id.* at *8. The court acknowledged that “whether interest will be allowed at the default rate is determined on a case-by-case basis and is fact specific,” *Id.* at *7, and that it must “read the terms of the Loan Documents in context, giving each term its plain meaning.” *Id.* at *3.

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