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Caution to Lenders – New Pitfalls to Imposing Default Interest and Late Fees on Defaulted Loans

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On September 29, 2022, the California Court of Appeal First Appellate District, in *Honchariw v. FJM Private Mortgage Fund, LLC,* held a private lender's imposition of late charges and default interest constituted an unlawful penalty in contravention of the public policy set forth in California Civil Code Section 1671, reversing the trial court's finding. The California Supreme Court denied review, leaving the appellate decision in place as the current law in California.

In 2018 Nicholas and Sharon Honchariw obtained a $5.6 million dollar bridge loan with FJM Private Mortgage Fund, LLC, a private lender, secured by a first deed of trust on commercial real property. On September 1, 2019, the Honchariws defaulted under the loan by missing their monthly payment in the amount of $39,667. The default triggered an automatic imposition of (1) a one-time late payment fee ($3,967), which was 10% of the missed monthly payment, and (2) default interest of 9.99% per annum over the note rate, charged against the unpaid loan balance (collectively, the "Late Fee Provisions"). The Honchariws filed a demand for arbitration alleging, among other things, that the Late Fee Provisions were an unlawful penalty in violation of Section 1671 of the California Civil Code. FJM Private Mortgage Fund, LLC, prevailed in the arbitration. The Honchariws then filed a petition to vacate the arbitration award on the basis that the arbitrator exceeded their authority by denying, in part, the violation of Section 1671. The trial court denied the petition finding that the Honchariws failed to meet their burden of proof to show that the default interest under FJM's loan was an illegal penalty. The Honchariws appealed.

Section 1671 of the California Civil Code provides, in part, that a liquidated damages provision under a *non-consumer* contract is presumed valid. Notwithstanding that presumption, the Court of Appeal in the Honchariw case concluded that a liquidated damages provision in a non-consumer contract must bear a "reasonable relationship" to the actual damages that the parties anticipate would flow from a breach under the agreement. The Court's reasoning relied on a prior case, *Garrett v Coast & Southern Fed. Sav. & Loan Assn,* 9 Cal. 3d 731 (1973)*,* wherein the imposition of a late fee provision that increased the interest rate on the entire unmatured loan

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was held to be unenforceable as an attempt by the creditor to coerce timely payments by a forfeiture, which was not reasonably calculated to merely compensate the injured lender.

The Court of Appeal in Honchariw focused on the imposition of default interest on the unpaid balance of the entire loan and held that the increased interest rate on the unpaid balance of the loan did not bear a reasonable relationship to FJM's actual damages. Therefore, under the Court's reasoning, it constituted an unlawful penalty and was thus unenforceable.[2] To add insult to injury, the Court awarded the Honchariw's their legal fees on appeal.

The Court did not address how a lender can prove its actual damages in order to satisfy the requirement that its default interest bears a reasonable relationship to the lender's actual damages. The most significant damages would likely be in the form of the increased credit risk resulting from the defaulted loan. But these damages may be hard to quantify. A lender might be able to support its damages claim with evidence of the cost of sending a notice of default, assigning a loan to special assets, increased monitoring of the loan, etc. But this may be burdensome to calculate and might turn out to be far less than the default interest. The facts of each situation will likely be different.

The holding in the Honchariw case left many questions unanswered. Would a contractually agreed increased interest rate (e.g., under a forbearance agreement) pass muster? Can a lender legally impose default interest when multiple covenant defaults (but no payment defaults) exist? The Court provided no guidance.

What is clear under the Honchariw case is that, in a loan transaction governed by California law, a lender must be prepared to show that default interest bears a reasonable relationship to the lender's actual damages, and cannot be used to coerce payment.

Finally, there are good reasons to believe the Honchariw case was wrongly decided and will in time be overruled. It is based on the Garrett decision cited above that predated the Legislature's 1978 amendments to Civil Code section 1671, which changed the presumptions concerning liquidated damages.[3] Late payment fees and default interest provisions are found in virtually every commercial note and loan agreement. Many lenders will be surprised to learn that default interest as a tool for dealing with a troubled loan has been removed from their "troubled loan tool box." Without the ability to charge default interest to compensate for the increased credit risk, lenders

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[2] The court in *Honchariw* did not distinguish between the one-time 10% late fee charge on the missed payment and the imposition of default interest on the unpaid balance of the loan when making its determination that the Late Fee Provisions were unenforceable.

[3] On December 9, 2022 Buchalter, representing the California Bankers Association as amicus curiae, submitted a letter to the California Supreme Court in support of review of the Honchariw case, or in the alternative, request for depublication.

may forgo loan workouts in favor of acceleration and foreclosure. For this reason some lenders may be tempted to charge default interest despite the Honchariw case in the hopes that, if challenged, another Court of Appeal will rule in their favor[4] and/or attempt to thread the needle with their situation and hope that their facts sufficiently distinguish their situation from those in the Honchariw case. Any lender considering that strategy should first consult with experienced counsel and be prepared for possible adverse legal consequences. After all, Honchariw, regardless that it may have been wrongly decided is, for the time being, the current law in California.

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[4] Trial courts in California will be bound by the Honchariw case.