

CALIFORNIA COURT OF APPEALS INVALIDATES DEFAULT INTEREST PROVISION

Most courts inherently do not like default interest because they see it as an improper “penalty.” Here’s what the First District of the California Court of Appeals recently found in *Honchariw v. FJM Private Mortgage Fund, LLC*.

Default interest is a hot button for borrowers, lenders, and the courts. Most courts inherently do not like default interest because they see it as an improper “penalty.” That is the exact result reached on September 29, 2022, by the First District of the California Court of Appeals in *Honchariw v. FJM Private Mortgage Fund, LLC*.

THE FACTS

In 2018, the Honchariws took out a \$5.6M bridge loan. In the event of default, the Honchariws agreed that FJM could charge both a one-time 10% late payment fee of roughly \$39,000 and default interest of 9.99% on the entire loan balance. The loan documents even went so far as to explain that these charges are necessary because a default “will result in [FJM] incurring additional expense in servicing the loan, including, but not limited to, sending out notices of delinquency, computing interest, and segregating delinquent sums from the not delinquent sums on all accounting, loan and data processing records, in loss to [FJM] of the use of the money due, and in frustration to [FJM] in meeting its other financial commitments.” This language appears intended as an agreement

between the parties that the late charge and default interest were justified as compensation to FJM resulting from the default. These provisions (or similar ones) are common to many non-consumer loan documents.

After missing a monthly payment, FJM declared the loan in default and assessed the one-time late charge and added the default interest to the entire loan balance. The Honchariws initiated arbitration to dispute both charges. The arbitrator ruled in FJM’s favor, finding that the charges were not a penalty. The Honchariws’ attempt to vacate the arbitrator’s award was also denied, leading to this appeal.

THE DECISION

In a published decision, the Court of Appeals vacated the Arbitrator’s award, finding that

the default interest provision was an unlawful “penalty” and, therefore, unenforceable. The decision starts by correctly determining that liquidated damage provisions are presumed valid when involving a non-consumer loan and presumed invalid when involving a consumer loan. Since this case involved a non-consumer loan, the Honchariws have the burden to prove that the default interest provision is invalid by showing that the amount of damages does not bare a “reasonable relationship” to the damage that will be caused by the default. In other words, if the default interest charge is \$100,000, the borrower must prove that the lender will not incur \$100,000 of additional expense or loss as a result of the default. Rather than point to any evidence presented by the Honchariws showing that the default interest was not reasonably related to FJM’s loss, the court concluded that the mere fact that default interest is being charged on the entire loan balance is, in and of itself, a violation of public policy and therefore, the Honchariws had met their burden.

TAKEAWAYS

The court focused its decision on default



interest charged on the entire loan balance following a monthly payment default. The court distinguished contrary case law supporting the validity of default interest charged on the entire loan balance following the maturity of the loan. As a result, charging default interest on the remaining loan balance following the maturity of the loan should be unaffected by this decision. Likewise, this decision arguably does not affect a lender's right to charge default interest on amounts in default. Questions also remain about whether a lender can charge default interest on

an amount less than the entire unpaid balance. Of course, any default interest charge must still be reasonably related to the potential loss caused by the default.

Going forward, we recommend that lenders consult with an attorney before charging any default interest. In addition, lenders should have their loan documents reviewed to maximize the ability to charge default interest in the future.

WFZ is discussing with the California Mortgage Association and other industry groups about filing an amicus briefs to support FJM's

anticipated Petition for Review by the California Supreme Court and, if accepted, the California Supreme Court review.



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