

California Court of Appeal Ruling Limits Application of Default Interest

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The California Court of Appeal recently ruled that California law treats default interest measured against the unpaid principal balance of a loan as an unenforceable penalty. In *Honchariw v. FJM Private Mortgage Fund, LLC* (see [link](#)), the court held that under section 1671 of the California Civil Code, a default interest charge must bear a “reasonable relationship” to the lender’s actual damages from the breach to be enforceable. The borrower in *Honchariw* prevailed because the court concluded that on its face, a charge of 9.99 percent of the remaining principal balance of the loan imposed after one missed monthly payment did not bear a reasonable relationship to the lender’s actual damages.

Section 1671 provides that for “non-consumer contracts” like the one at issue in *Honchariw*, liquidated damages for a breach are valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made. Here, the court determined that the default interest provision was contrary to public policy and therefore unreasonable by definition. The court cited from a 1973 California Supreme Court decision that it is the public policy of California that “[t]he amount set as liquidated damages ‘must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained.’ In the absence of such relationship, a contractual clause purporting to predetermine damages ‘must be construed as a penalty.’” (*Garrett v. Coast & Southern Fed. Sav. & Loan Assn.* (1973) 9 Cal.3d 731, 739.) The *Garrett* decision concluded that “a charge for the late payment of a loan installment which is measured against the unpaid balance of the loan must be deemed to be punitive in character.” *Garrett* at 740. **The *Honchariw* court summed up its position by saying that “*Garrett* remains good law for the proposition that a late fee assessed against the entire unpaid balance of a loan constitutes an unlawful penalty and there is nothing in current section 1671 or the case law following *Garrett* holding otherwise.” *Honchariw* at 8.**

It is important to note that a lender’s ability to impose default interest on the outstanding principal balance of a loan upon a maturity default or acceleration (depending on the wording of the agreement) does not appear to be impacted by the *Honchariw* case. In addressing arguments made by the lender in *Honchariw*, the court specifically distinguished between missing installment payments on “partially matured obligation[s]” and a default at the loan’s final maturity date. *Honchariw* at 12.

For those contemplating or currently engaged in business in California, lenders to commercial borrowers should be mindful that late fees or any charges assessed which do not bear a reasonable relationship to the total amount due may amount to unlawful liquidated damages, unenforceable in a court of law in California or under California law. Further, such commercial borrowers may seek fees and costs as were awarded in *Honchariw*. Additionally, if other late payments are tied to the default interest provision, they also may be at risk of being invalidated.

CONTACTS

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