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Some Thoughts on Late Charges and Default Rate Interest

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In mortgage loan transactions, lenders will customarily charge a fee for late payments and additional (or default) interest upon a default. The late fee is often a percentage (*e.g.*, five percent) of the unpaid installment and is meant to compensate the lender for its administrative costs in handling and processing the delinquent payment and for the loss of the use of such delinquent payment. Default rate interest, on the other hand, is an increase in the interest rate by a specified percentage in the event of a default and is meant to compensate the lender for its increased risk in dealing with a borrower that has defaulted. Default interest is also meant to compensate the lender for any lost opportunity cost in reinvesting the loan proceeds and for its costs in administering a defaulted loan.[1] Finally, default interest serves as a deterrent to a borrower from defaulting a loan.

One issue that arises with respect to late charges is whether a late charge may be applied on the payment at maturity. Borrowers routinely object to charging a late charge on the balloon payment. In *Trustco Bank New York v. 37 Clark Street, Inc.*, the mortgage note provided that a late charge of six cents for each dollar overdue could be assessed "for the purpose of defraying the expense incident to handling delinquent payment." The borrower failed to make a payment of the entire amount due under the note at maturity, and following that default, the lender accelerated payment. The lender sought to recover the late charge for the failure to make the balloon payment, and the borrower objected, arguing that the late charges were an "oppressive forfeiture" and impermissible penalty. The Court held that the late charge provision must be construed to apply only to defaults in monthly payments giving rise to collection expenses, not defaults of payments at maturity, such as a balloon payment resulting in acceleration. Such defaults, the Court noted, terminate the borrower's right to correct the default. As a result, late charges did not apply to the balloon payment.[2]

In determining the enforceability of both late charges and default rate interest, courts have considered whether the amounts charged have a punitive intent. If charges are so high as to suggest a punitive intent rather than an intent to compensate the lender for its costs, courts have invalidated them. In *Emigrant Funding Corporation v. 7021 LLC*, the contract interest rate was 7.25% and the default rate interest was 24%. The Court reasoned that parties are free to agree that a contract rate of interest will increase upon a default, so long as the interest rate is not usurious or does not constitute a penalty. In this case, the lender charged the borrower both the contract rate of interest and the default rate interest during the periods of time when the borrower defaulted in making timely installment payments. The Court held that the charging of default rate interest in the amount of 24% in addition to the contract rate of interest of 7.25%, which results in a total charge of interest of 31.25%, was criminally usurious. While each case is fact-specific, criminal usury in New York rarely applies to larger loans with sophisticated parties given existing statutory exemptions. However, the Court rejected the borrower's argument that a 24% default rate of interest was a penalty and void as against public policy. The Court held that the default rate interest provision was valid and enforceable, noting that "it is well settled that an agreement to pay interest at a higher rate in the event of default or maturity is an agreement to pay interest and not a penalty."[3]

Another consideration for default rate interest is when it should be triggered – upon the occurrence of an event of default or when the lender accelerates the loan. Lenders would prefer the former, while borrowers would prefer the latter. In *In re Crystal Properties, Ltd., L.P.*, the promissory note stated: "Should default be made in any payment provided for in this note, … at the option of the holder hereof and without notice or demand, the entire balance of principal and accrued interest then remaining unpaid shall become immediately due and payable, and thereafter bear interest, until paid in full, at the increased rate of five percent (5%) per annum over and above the rate contracted for herein. No delay or omission on the part of the holder hereof in exercising any right hereunder, … shall operate as a waiver of such right or any other right under this note…" The lender argued that because the note expressly stated that default rate interest is due and payable upon default "without notice or demand," the default rate interest should have accrued at the moment of default. However, the Court disagreed, noting that the language "at the option of the holder" provides that the right to accelerate the unpaid debt is at the lender's option. Further, if the option is exercised, the note will "thereafter" bear interest at the default rate, and that can only mean that the default rate interest does not become effective unless the holder of the note exercises its option to accelerate. Consequently, the Court concluded that the language of the note required the holder to exercise its option to accelerate before the default interest rate is triggered.[4]

In financing transactions, many borrowers will negotiate default rate interest provisions further to clarify whether the default rate interest accrues from the occurrence of the default or from the occurrence of an event of default. Many times, an event of default may not occur until a significant grace period has elapsed (such as thirty, sixty or ninety days), and many lenders are loath to allow the accrual of default rate interest to be tolled for such an extended period of time. Lenders will argue that if the default never ripens into an event of default, then the default would have been cured and the relevant issue would be rendered moot.

Late charges and default rate interest are monetary issues which should be carefully drafted to ensure that the parties have contracted for what ultimately will be enforceable and what was intended by the parties.

[1] The Law of Real Estate Financing, § 5:106.

[2] Trustco Bank New York v. 37 Clark St., Inc., 157 Misc. 2d 843, 599 N.Y.S.2d 404 (Sup. Ct. 1993).

[3] Emigrant Funding Corp. v. 7021 LLC, 25 Misc. 3d 1220(A), 901 N.Y.S.2d 906 (Sup. Ct. 2009).

[4] In re Crystal Properties, Ltd., L.P., 268 F.3d 743 (9th Cir. 2001).