Default Interest In Light of *Honchariw v. FJM Private Mortgage Fund, LLC*

What do you do now?

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The commercial lending industry is trying to adjust to life after the California First District Court of Appeal's decision on September 29, 2022 in *Honchariw v. FJM Private Mortgage Fund, LLC*. At least two major loan servicers, citing the fear of class actions, have said they will not impose default interest on an unmatured loan.

In *Honchariw,* a California Finance Lender imposed a 10% late charge computed against a missed payment on a \$5.6M commercial loan and raised the interest rate from 8.5% to 9.99%, which was computed on the unpaid principal balance. Both are quite common features of most commercial loans written in California today. In fact, upon default some lenders impose increases of 6 to 10 percentage points over the note rate.

In our opinion, the case may be overturned on appeal or review by the full complement of judges in the First District Court of Appeal. First of all, the Court was reviewing an arbitration award. The law is clear that an arbitrator's award cannot be overturned merely because the court reviewing the award disagrees with how the arbitrator interpreted or applied the law. But the Court can review and correct applications of the law that violate certain "unwaivable statutory rights" or that "contravenes an explicit legislative expression of public policy." *Richey v. AutoNation, Inc.* (2015) 60 Cal.4th 909, 916. In *Honchariw*, the Court found that the liquidated damages provisions in Civil Code 1671 were such unwaivable rights but the authority it cites for that conclusion is suspect. Section 1671 contains no hard stop. It merely declares broad principles that are subject to application based upon the specific facts of a case. It is the function of the arbitrator to make those interpretations. On appeal, a court could easily reverse the case on this point alone and avoid the thorny default interest issue. After all, a policy of the law is to promote the arbitration of disputes to increase the speed of decisions, decrease costs, and put less stress on the court's calendars. Having a reviewing court correct errors of law in arbitration awards encourages post arbitration court challenges that the system of arbitration was mean to avoid.

On the default interest merits, the Court of Appeals, without authority, simply leapt to the conclusion that default interest provisions are late charges. Late charges are computed on monthly payments and default interest is a rate adjustment. They have nothing in common. Late charges deal with the annoyance of a monthly payment past a grace period, a thing Catholics would call a "venial" sin. Default interest adjusts the cost of money itself due to a borrower-created change in the risk environment - a "mortal sin." Many lenders, including consumer lenders like banks that issue credit cards, charge both prepayment penalties and default interest for different reasons. An increase in the interest rate is justified by the material change in a mortgage loan once it is in default even if it is a pre-maturity payment default.

First of all, a lender may have to remove the loan from the credit facility that it uses to finance the loans in its portfolio. That requires putting the loan back on the lender's balance sheet, which deprives the lender of cash from its credit facility to replenish its lending ability. Second, the ability of the lender to sell the loan at par or better is impacted because a buyer will not pay full price for a loan in default. Without a resale, the lender's capital cannot be replenished to make new loans and generate new origination income. Third, if the lender has investors, it has to report defaults to them, and this reduces the attractiveness of the lender as a good place to invest money – thereby increasing the cost for the lender to raise additional equity capital to lend. Fourth, upon default a lender is forced to expend personnel resources to deal with the borrower's plight and to determine if there is a solution. Fifth, upon default, a lender may have to add amounts to its loan loss reserve, which impacts its profitability. We could go on and on with all of the negative impacts on a mortgage lender when loans go into default, but it is obvious that a default has many negative repercussions - all of which are costly. At the arbitration, either the lender did a poor job of presenting evidence of these damages, or presented them, and the arbitrator did not elaborate on them in the arbitration award.

So what do you do now? Two questions confront you. First, do you take default interest out of the new loan documents that you are writing now? Second, if you have or expect to have loans that accrue default interest, should you move the all of your loans to a servicer that will bill and collect it?

On the first point, there are good reasons to stay the course and include the default interest provision. A good default rate provision should not be operative until the borrower is at least 30 days delinquent (and has been notified that the rate will increase to the default rate) - that is a serious delinquency and one that does not overlap the typical 10-day grace period. That way, you are protected if the case is reversed. After all, no one can complain unless and until you actually charge them default interest. Until the case is reviewed either by the full Court of Appeal or the California Supreme Court, be prepared for some pushback from those borrowers savvy enough to find this case and attempt to assert it. If that happens, be prepared to negotiate a discount of the default interest in exchange for a full release.

You should think twice about changing servicing relationships. First, it is a tremendous amount of work and confusion. Second, the choice of servicers as to default interest is only relevant if there is a foreclosure or a payoff. If your servicer issues a payoff request that does not include the default interest you think you are entitled to, then you can pull the servicing of that loan and either self-service it until payoff, or board it elsewhere. Since the servicer will not show default interest on any monthly billings, to avoid waiver arguments, you should notify your defaulting borrower at the inception of a default that, although default interest may not show up on monthly statements from the servicer, it is nonetheless being charged. Lastly, be sure to include what the default interest rate is, and how much of a dollar amount at which it is accruing daily.

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