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LENDING AND RESTRUCTURING ALERT

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May a Lender Collect Late Charges Together with Default Rate Interest?

The answer will depend largely upon the relative size of the late charge that the lender seeks to collect, industry standards, and whether the lender seeks to collect late charges before or after maturity/acceleration. Recently, a Connecticut state court ruled that a lender may not collect a late charge on the full balance of a loan following maturity where the lender also received default interest. Notably, the Court determined that the lender's late charge on a balloon payment was exorbitant, and awarded the borrower damages for emotional distress suffered as a result of its imposition. In contrast, the New Jersey Supreme Court permitted a lender to collect simultaneously both default interest and late charges on unpaid installments.

The Recent Connecticut Decision

A borrower's loans aggregating over $1,500,000 matured. The lender sought to impose a late fee on the unpaid balloon balance of 4%, approximately $64,000. The borrower refused to pay it, and this dispute prevented the parties from entering into a forbearance agreement. The bank seized the borrower's bank accounts and accounts receivable, and auctioned its inventory. The borrower sold its real property and repaid the lender in full at closing, including the late charges. The borrower and its principal then sued the lender.

The borrower argued that the default rate interest compensated the lender for its loss caused by the default, and that the imposition of a late charge was an impermissible penalty. The court agreed, holding that a lender may not collect, after the full amount of the loan became due, both a late charge and default rate interest.

The court further stated that the late charge was not enforceable because it was exorbitant and there was no reasonable relationship between the loss the bank suffered due to the default and the amount of the late charge. Surprisingly, the court was convinced that the borrower's principal suffered emotional distress as a result of the exorbitant late fee and ordered the lender to repay the late fee, plus $15,000 for emotional distress.

The New Jersey Supreme Court Allowed Late Charges and Default Interest

In a case where Herrick successfully represented the lender, the New Jersey Supreme Court ruled that a lender may collect simultaneously both reasonable late fees on unpaid installments and default interest.

The case involved a $1,500,000 loan. The lender sought to impose late charges of 5% on 40 late installments. The lender also sought to collect default interest of 15% (the nondefault rate was 9.55%) because a $1,391,000 balloon payment was not made upon maturity. Wisely, the lender did not seek late charges on the balloon. The borrower asserted that the lender should not be permitted to collect either the late charges on the unpaid installments or the default interest.

The trial court held that a 5% late fee constituted reasonable liquidated damages, but reduced the allowable default rate from 15% to12.55%. The Appellate Division reversed, holding that both the late charges and default interest were unenforceable penalties. This triggered an appeal by the lender to New Jersey's highest court.

The New Jersey Supreme Court found the 5% late charge to be a valid measure of liquidated damages, because each side to the transaction was sophisticated and represented by counsel, the late charge was within the industry standard, and it was intended to compensate the lender for the costs associated with administering late payments. The court also found that the default rate of 12.55% imposed by the trial court was reasonable under the circumstances. The court concluded that the default rate was consistent with the industry standard and did not represent an exorbitant increase from the non-default rate, but was a reasonable estimate of the cost of administering a defaulted loan.

Implicitly, this decision supports the proposition that a lender may collect both default rate interest and late charges where a loan is in default but has not matured or been accelerated.

What About New York Law?

Consistent with the laws of other states described above, New York courts permit a lender to collect late charges on unpaid installments after default but before acceleration. After acceleration, no additional late charges may be assessed.

What to Do? What to Expect?

The prudent lender should review its form loan documents to determine whether the late charges assessed are reasonable in light of standards in the lending industry and whether they reflect reasonable costs associated with administering late payments. A lender should also bear in mind that a court may review the parties' relative bargaining power and sophistication when deciding a dispute over late charges. The lender should not expect to be able to collect late charges for payments not made following acceleration or maturity.

An award of damages for emotional distress suffered by a borrower due to assessment of a large late fee is extreme and rare. Nevertheless before seeking to collect late charges, it is worthwhile for a lender to consider whether, in light of the amount of missed payment(s), the late charges might be considered exorbitant.

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