

## **Default Interest Rates, Late Charges and Exit Fees: Are They Enforceable?**

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### **Introduction**

Mortgage lenders customarily charge mortgagors additional interest upon default, based on a percentage increase in the contract interest rate. In addition, they usually charge mortgagors a fee for late payment of installments on the note, often based on a flat percentage if the payment is not made on the payment date or within a specified period of time thereafter. In recent years, especially in connection with securitized loans and mezzanine financing, mortgagees also have commonly inserted "exit fee" provisions in mortgage loan documents, requiring mortgagors to pay a specified fee for prepayment or at the maturity (whether voluntary or involuntary) of the loan. Recent case law has wrestled with the issue of whether these charges and fees are enforceable, i.e., should they be enforceable only if they are "reasonable" and justifiable based on the mortgagee's actual or anticipated costs – or should they be not be subjected to this, or any other, test as long as they are entered into by sophisticated parties and are not "unconscionable"? Unfortunately, the case law is conflicting and contradictory and fails to provide clear guidelines for the imposition and calculation of such charges and fees.

### ***MetLife*: The New Jersey Appellate Court Decision**

In *MetLife Capital Financial Corp. v. Washington Ave. Assocs.*, 313 N.J. Super. 525, 713 A.2d 527 (1998), the New Jersey Appellate Court, using a liquidated-damages analysis, ruled that a 5% late charge and a 15% default rate of interest contained in a mortgage note did not comply with the requirements of a valid liquidated-damages provision under New Jersey law. The court found that these charges were not reasonably related to the anticipated or actual damages incurred by the mortgagee, which the court held were capable of exact determination and were therefore not unascertainable or difficult to prove. The court cited the RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981), which states: "Damages for breach by either party may be liquidated in the agreement but only in an amount that is reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

The court also rejected the argument by the mortgagee that such charges were "customary" or "industry standard." Instead, the court required the mortgagee to prove that actual losses were incurred and the exact amount of such losses. The court found that the testimony of the mortgagee's officers was insufficient in this regard.

For similar rulings, see *In re 1095 Commonwealth Ave. Corp.*, 204 B.R. 284, 304-05 (Bankr. D. Mass. 1997) (allowing recovery at default rate of interest but precluding recovery of late fees because "[b]oth the late charge and the default rate of interest are intended to compensate the lender for the increased costs of administration caused by the borrower's failure to make payment as and when it is due"); *In re Vest Assocs.*, 217 B.R. 696, 701 (Bankr. S.D.N.Y. 1998) ("oversecured creditors may receive payment of either default interest or late charges, but not both"); *In re Udhus*, 218 B.R. 513, 517 (9<sup>th</sup> Cir. 1998) (holding that a cure pursuant to an approved Chapter 11 plan of reorganization prevents application of default interest; the court stated that "since the loss of opportunity costs is the same as the loss of default interest, it would be unreasonable to include this part of the claim as an allowable administrative expense"); *In re Hollstrom*, 133 B.R. 535, 539-40 (Bankr. D.Colo. 1991) (ruling that a 36% rate of interest would be deemed a penalty where the non-default rate was 14% and there was no evidence presented to justify application of the default rate); *In re White*, 88 B.R. 498, 511 (Bankr. D. Mass. 1988) (finding that a 48% default rate of interest was unreasonable, and therefore a penalty, where the non-default rate was 16.5% and grossly disproportionate to the damages resulting from the breach); *In re Boardwalk Partners*, 171 B.R. 87, 92-93 (Bankr. D. Ariz. 1994) (holding that a 25% default rate of interest, which constituted a 14.5% spread over the non-default rate, was a penalty); *In re DWS Investments, Inc.*, 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990) (25% default interest rate deemed a penalty); *Fischer Enterprises, Inc. v. Geremia (In re Kalian)*, 178 B.R. 308, 309 (Bankr. D. R.I. 1995) (holding that a spread of 18% between the default rate and the non-default rate constituted a penalty); *In re Boulders on the River, Inc.*, 169 B.R. 969, 975 (Bankr. D. Or. 1994) (disallowing a claim for default interest at a rate 5% higher than the contract rate because the court was not "persuaded that the default rate of interest constitutes anything but a mere penalty"); *Key Bank Nat'l Ass'n v. Milham (In re Milham)*, 141 F.3d 420, 423 (2<sup>nd</sup> Cir. 1998), *cert. denied*, 119 S.Ct. 169 (1998) ("Most courts have awarded pendency interest at the contractual rate; but nevertheless, however widespread the practice may be, it does not reflect an entitlement to interest at the contractual rate"); *Bradford v. Crozier (In re Laymon)*, 958 F.2d 72, 75 (5<sup>th</sup> Cir. 1992), *cert. denied*, 506 U.S. 917, 113 S.Ct. 328 (1992) (holding that the "rate of interest [chargeable under § 506(b)] should be determined 'by examining the equities involved in the bankruptcy proceeding'"); *Garrett v. Coast Fed. Sav. & Loan Ass'n*, 9 Cal.3d 731, 735-36, 108 Cal.Rptr. 845, 847-48, 511 P.2d 1197, 1199 (1973) (holding that imposition of late charge was an invalid attempt at liquidated damages).

### ***MetLife: The New Jersey Supreme Court Decision***

On June 30, 1999, the Supreme Court of New Jersey, in *MetLife Capital Financial Corp. v. Washington Avenue Associates*, 159 N.J. 484, 732 A.2d 493 (1999), reversed the decision of the appellate court, which had held that MetLife's imposition of a late charge of 5% of the delinquent payment, as well as a default interest rate at "the greater of five percent (5%) per annum in excess of the 'prime rate' . . . from time to time, or

fifteen percent (15%) per annum," were unenforceable penalties under a liquidated damages analysis. (MetLife had not appealed the appellate court's reduction of the default interest rate to 12.55%, which was 3% greater than the non-default contract interest rate).

The New Jersey Supreme Court first addressed the issue of the reasonableness of the late charge. The court reviewed the history and development of stipulated damages provisions, including case law and the UCC provision on liquidated damages, and concluded that, "'reasonableness' emerges as the standard for deciding the validity of stipulated damages clauses." Utilizing the "reasonableness" test, the court held that the five- percent late charge was "a valid measure of liquidated damages." The court explicitly disagreed with the finding of the appellate court that damages arising from a late payment with respect to a larger loan would not result in a greater administrative or "opportunity cost" risk to the lender, or require greater oversight and supervision. The court also noted that it would be impractical to require the lender to calculate its exact damages with respect to a specific defaulted loan, because the lender's costs are spread over its entire portfolio of loans.

It would be more realistic, the court found, to examine the statutory treatment of late charges as well as common and accepted practice in the industry. Under this standard, the court ruled that the reasonableness of the charge had been successfully demonstrated based on the following factors: the uncontradicted testimony of MetLife's representative that the charge was customary in connection with commercial mortgage loans and fairly compensated the lender for the administrative costs involved in connection with servicing delinquent loans; the express authorization, under both New Jersey statutes and numerous federal statutes and regulations governing various classes of mortgage lenders, of late charges of five percent; case law from other jurisdictions generally upholding fixed percentage late charges negotiated between sophisticated commercial entities, which were within the "industry standard" range; the "suggestion" of case law from New Jersey and other jurisdictions that a small percentage late charge was simply a normal part of the cost of doing business; and the failure to demonstrate any evidence of fraud, duress or other unconscionable acts on the part of MetLife.

The court then turned to the issue of the reasonableness of the default interest rate. Consistent with its holding on late fees, the court noted that, "[d]efault interest rates, like late fees, are presumed reasonable." The court's review of New Jersey case law in this area revealed that a default interest rate would be invalidated as a penalty if "the[] size suggests a punitive intent." Because the interest rate increase in this case was only three percent, the court found it to be "a reasonable estimate of the potential costs of administering a defaulted loan, and the potential difference between the contract rate and the rate that MetLife might pay to secure a commercial loan replacing the lost funds." The court noted the difficulties faced by lenders in determining actual losses resulting from a commercial loan default; in predicting the nature and term of a loan default or market conditions for commercial loans in the future; in predicting their economic losses and what might ultimately be recovered from a foreclosure sale; in

determining what their own borrowing costs might be in the future; and in estimating their collection costs.

The New Jersey Supreme Court did rule against MetLife on the remaining issue in the case, regarding an accounting of the rents that MetLife had collected directly from the tenant after the borrower's default. MetLife had relied on its "absolute" assignment of rents under which, the court agreed, title to and possession of the rents passed to MetLife upon the borrower's default. The court upheld the ruling of the appellate court on this issue, and found that "in the absence of any accounting, and in light of prior precedent, the express contractual provision, and considerations of equity," it would remand the case for a determination of the amount that should be credited to the mortgage loan as the result of MetLife's failure to account for the rental payments or apply them to the principal balance of the loan. (The court noted that "MetLife may have secured an interest-free loan for itself at [the borrower's] expense . . .").

Based on existing case law and standard mortgage practice that has existed for quite some time, the appellate court's holding in the *MetLife* case truly appeared to be an aberration - one that the New Jersey Supreme Court has now rectified. As the court noted, it has adopted the "modern trend" that permits more flexibility when analyzing the reasonableness of late charges and default interest rates in commercial loan documents. The court appears to be moving toward a "consenting adults" approach, under which almost anything goes when sophisticated parties, represented by counsel, are involved in negotiating complex commercial real estate financing transactions -- as long as the fees and charges imposed are within industry-standard norms and ranges and don't appear to be clearly "unconscionable." At the end of its opinion the court acknowledged that the imposition of late charges and default interest rates is a "practical solution to the problem of pricing loans according to anticipated rather than actual performance and the difficulty in allocation and determining the costs and damages of late payments and default," and agreed that "[t]he alternatives are economically inefficient or judicially impracticable." Interestingly, however, the court rejected MetLife's argument that late charges and default interest rates should be analyzed strictly in accordance with contract law principles, and should not be subjected to a liquidated damages analysis because of the "fiercely competitive marketplace" and the difficulty of calculating actual damages. Although agreeing with MetLife that the imposition of such charges is a legitimate cost of doing business, the court was not prepared to go as far as to incorporate such a factor into the "reasonableness" test. Rather, the court stated its belief that courts are "accustomed to dealing with the standard of reasonableness," and that it would continue to evaluate late charges and default interest rates under this standard, instead of employing an "unconscionability" test. According to the court, the continued use of the "reasonableness" standard would "provide[] an adequate safeguard for the lenders and better protection for the borrowers."

### **The *MONY Life Ins. Co. Decision***

In *MONY Life Ins. Co. v. Paramus Parkway Bldg., Ltd.*, 364 N.J. Super. 92 (N.J., Super. Ct. App. Div. 2003), the New Jersey appellate court (affirming prior New Jersey rulings) ruled that certain lender charges in commercial mortgage transactions that constitute (in the court's view) liquidated damages, such as late fees, default interest rates, and prepayment premiums are subject to the test of "reasonableness" and are not subject to an unconscionability standard where the parties to the transaction are sophisticated and experienced, and that the borrower could not challenge the default interest rate, prepayment premium, or other contractual penalties negotiated as part of a loan workout with the lender. (Although the court mentions late fees in the preamble to the opinion, there is no discussion of late fees elsewhere.)

The defendant borrowed \$6.9 million from the lender and executed a mortgage for this amount on the debtor's warehouse and office facility. Later, after various defaults by the borrower, the parties entered into a mortgage modification agreement that extended the maturity date, provided for a default rate of six percent over the contract rate of nine percent, and added a prepayment charge of three percent of the principal amount commencing on November 1, 1995, declining one half of one percent per year.

The borrower again defaulted, and the lender filed a state foreclosure action. The borrower then filed various (and basically bogus!) defenses, alleging that the note and mortgage were void due to "illegal and unconscionable penalties contained therein." A receiver was appointed who, after initial failure to cooperate by the borrower, began collecting the rental income. A final judgment of foreclosure was entered, which included interest at the default rate and the prepayment charge as set forth in the modification agreement. Before the sheriff's sale, the borrower found a purchaser for the property (for an amount over \$2.5 million more than what was owed on the mortgage!) and paid off the mortgage "under protest and without waiver of any of [its] rights and/or remedies." The lender then dismissed the foreclosure action and the sale was closed. Subsequently, the lender revised its payoff figure downward and refunded approximately \$93,500 to the borrower, stating that the check for this amount was being tendered "with a complete reservation of [the lender's] rights and remedies and a waiver of none." The borrower returned the check, claiming that it had overpaid by an amount greatly in excess of the amount tendered, and reserving all of its rights and remedies.

The borrower then appealed the judgment of foreclosure, arguing that the lender's motion for final judgment should not have been granted because the borrower had contested the amount that was claimed to be due and owing and had not had a chance to complete discovery of the issue of whether such amounts were reasonable. In particular, the borrower asserted that (1) the principal indebtedness had not been properly calculated, (2) the 6% default interest rate was "a penalty and unenforceable," (3) the prepayment premium was "illegal," (4) the interest on the debt had been miscalculated, and (5) the amount of attorney's fees demanded was excessive.

The court first ruled that the fact that the borrower had paid off the mortgage did not extinguish its right to challenge the foreclosure judgment. The court then made short shrift of the borrower's other arguments, deeming "these remaining issues to be without merit." The court noted that the borrower had not produced any evidence that the amounts owing under the loan documents were not correct nor had it challenged the principal amount claimed to be due, or alleged fraud, duress or any other unconscionable acts. The court also noted that the lender had discovered and acknowledged an overpayment by the borrower and refunded the balance owing to the borrower.

The court then dismissed the borrower's arguments regarding accrued interest, default interest, and the prepayment premium "for the same reason, "i.e., that such arguments were neither factually nor legally supported by the record. The court stated that in New Jersey, "liquidated damages, such as late fees, default interest rates, and prepayment premiums are subject to the test of reasonableness, that is, whether the stipulated damage clause is reasonable under the circumstances," citing the New Jersey Supreme Court's holding in *MetLife v. Washington Avenue Associates, L.P.*, *supra* (upholding as reasonable a late fee of five percent and default rate of 12.55%), and *Westmark Commercial Mortgage Fund IV v. Teen form Associates, L.P.*, 362 N.J. Super. 336, 341-42 (App. Div. 2003) (evaluating default rate in commercial contract using reasonableness standard, and determining that late fee of six percent (as opposed to five percent in *MetLife*) and default rate of two percent in excess of contract rate were reasonable in absence of any evidence to contrary). *Id.* at 103.

The court concurred with the conclusions of the courts in these cases, i.e., that various forms of special charges on default are customary and justified in commercial loan transactions between sophisticated parties represented by counsel, and are "presumptively reasonable" in such circumstances, shifting the burden of proving unreasonableness to the borrower. (Amazingly, the court notes in a footnote that "the general partner in Washington Avenue Associates, the defendant in *MetLife*, was Laurence S. Berger, who is also a principal of [the borrower] in this case," and was described by the judge in a prior decision as "a practicing attorney [who had] demonstrated a very high degree of sophistication in the area of mortgage lending." *Id.* at 103 n. 3). The court also noted that "[t]he certainty of the remedy provided by the clause undoubtedly affected the pricing of the loan," especially where, as in this case, there had been a pattern of prior defaults. *Id.* at 104.

### **Other Decisions Dealing with Default-Interest and Late-Charge Provisions**

Other courts, both bankruptcy and non-bankruptcy, have upheld the validity and enforceability of default-interest and late-charge provisions in commercial loan documents. See, e.g., *In re Route One West Windsor Limited Partnership*, 225 B.R. 76 (Bankr. D.N.J. 1998), in which the court, applying New York law (the parties had stipulated New York law would apply in a choice-of-law provision in the loan

agreement), held that a provision in the debtor's mortgage-loan agreement with an oversecured creditor to pay interest following default at the post-default rate of 15.125% was not an unenforceable penalty and must be paid by the debtor. The court found that the increased default rate of interest was justifiable and reasonable because it merely compensated the mortgagee for the increased risk and expense of collection. The court also held that the allowance of default interest on a claim in bankruptcy is determined by federal law, but noted that state law would be relevant because if the amount exceeded the allowable legal rate, then the bankruptcy court would not permit the mortgagee to recover such a windfall amount in a bankruptcy proceeding. The court also noted that the principal of the debtor was a sophisticated businessman who had knowingly and freely allowed the debtor partnership to contract for the post-default interest rate. The court further found that no other non-insider creditors of the debtor would bear the adverse effects of the increased rate of interest paid to the mortgagee. The court, citing *Metlife Capital, supra*, noted that, "under New Jersey law default interest rates that are penalties are unenforceable." *Id.* at 88. The court distinguished *Metlife Capital*, stating that "There is no question that default interest is generally permitted under New York law and is difficult to obtain under New Jersey law. Under New Jersey law a liquidated damages clause is only valid if (1) the amount fixed is related to the actual damage that is likely to be suffered, and (2) the amount of the damage caused by the breach is of the type which is incapable or very difficult to actually estimate." *Id.* at 99, fn.2. The bankruptcy court also noted that under New York law default interest rates as high as 25% had been consistently held to be reasonable. However, the court held that the mortgagee would not be permitted to receive both interest at the post-default rate *and* late charges. The court therefore upheld the enforceability of the default-interest provision but not the provision for the payment of late charges by the debtor. Finally, the court also ruled that the mortgagee would not be permitted to receive interest on the default interest that accrued post-petition. The court noted in support of this specific holding that the loan documents did not provide for the payment of such interest-on-interest and that the allowance of such additional amounts would not be equitable. See also *In re Wines*, 239 B.R. 703, 709 (Bankr. D.N.J. 1999) (citing the New Jersey Supreme Court's holding in *MetLife, supra*, and stating that "[a]lthough that decision does not apply to residential mortgages, courts have traditionally allowed late charges according to the contract of the parties"); *In re AE Hotel Venture*, 321 B.R. 209 (Bankr. N.D. Ill. 2003) (ruling that, under Illinois law, lender could not collect default interest and in addition to late fee unless it could prove that collection of late fee was insufficient to compensate it for its actual damages).

In *In re Dixon*, 228 B.R. 166 (Bankr. W.D. Va. 1998) (a decision similar to *In re Route One West Windsor Limited Partnership, supra*), the court held that, although the default interest rate of 36% (double the pre-default rate) was high, it would accept the creditor's representation -- without requiring testimony or evidence -- that the default rate was proportionate to the reasonably anticipated damage from default and was not a penalty. The court stated that it did not have the "power to alter commercial contracts or to substitute [its] judgment for that of the parties" where the transaction was lawful, no other creditors were harmed, the default rate did not violate state usury laws, and there was no threat to the reorganization of the debtor by imposition of the default rate. *Id.* at

174. The court, citing *In re Terry Ltd. Partnership*, 27 F.3d 241, 243 (7<sup>th</sup> Cir. 1994), *cert. denied sub nom Invex Holdings, N.V. v. Equitable Life Ins. Co. of Iowa*, 513 U.S. 948, 115 S.Ct. 360 (1994) and *In re Consolidated Properties Ltd. Partnership*, 152 B.R. 452, 457 (Bankr. D.Md. 1993), also stated that "[d]efault interest rates are also necessarily higher than basic interest rates in order to compensate creditors for both the predictable and unpredictable costs of monitoring the value of collateral in default situations." However, the court noted that "[e]ven when the late charge is reasonable . . . a creditor may be denied recovery where it also asserts a claim to a default rate of interest". *Id.* at 172.

See also *In re Venderveer Estates Holdings, Inc.*, 283 B.R. 122, 134 (Bankr. E.D. N.Y. 2002) ("Both the default interest rate of 12.56% [the non-default rate was 7.56%] and the differential of 5% between the default and non-default rates, are well within the range of default rates that would have been allowed as reasonable charges under § 506(b)"); *In re Southland Corp.*, 160 F.3d 1054, 1060 (5<sup>th</sup> Cir. 1998) (holding that recovery by the debtor of the contractual postpetition default rate was not inequitable where the 2% spread between the default and non-default rate was "relatively small," the mortgagee was "not obstructing the [bankruptcy] process," and no junior creditors would be harmed if the mortgagee was awarded default interest); *In re Liberty Warehouse Assoc. Ltd. Partnership*, 220 B.R. 546, 551-52 (S.D.N.Y. 1998) (stating that "[the mortgagee] is entitled to accrue pendency interest on its claim because it is oversecured" and finding that the default rate of 22.8% was reasonable and not a "disguised penalty," where the non-default rate was 14%; the court, citing *In re Ace-Texas, Inc.*, 217 B.R. 719,721 (Bankr. D. Del. 1998), also held that where the underlying debt has matured by its own terms, there is nothing for the mortgagor to reinstate and any attempt by the mortgagor to "cure" the default and reinstate the original terms would constitute an impairment of the mortgagee's right to immediate payment); *Bruce v. Martin*, 845 F.Supp. 146 (S.D.N.Y. 1994) (ruling that a default rate of 24.9% was allowable under New York Penal Law and was not usurious); *In re Terry Ltd. Partnership*, 27 F.3d 241, 243 (7<sup>th</sup> Cir. 1994) (finding that there is "a presumption in favor of the contract rate subject to rebuttal based on equitable considerations"); *In re Vest Associates*, 217 B.R. 696, 702-03 (Bankr. S.D.N.Y. 1998) ("the developing consensus is a presumption in favor of the contract default rate subject to equitable considerations," which the court defined as whether the default rate was "inordinately high" and whether the debtor was solvent); *Citicorp Mortgage, Inc. v. Morrisville Hampton Village Realty Limited Partnership*, 443 Pa. Super. 595, 600-01, 662 A.2d 1120, 1123 (1995) (finding that attorney's fee award of ten percent was reasonable, even though trial court did not specifically state reasonableness finding, where amount was provided for in loan documents and mortgagor had not set forth any evidence establishing its claim of unreasonableness); *In re Richardson*, 63 B.R. 112, 113 (Bankr. W.D. Va. 1986) (holding that oversecured creditor could recover late charges); *Mack Financial Corp. v. Ireson*, 53 B.R. 118, 120 (Bankr. W.D. Va. 1985) (holding that a creditor can obtain late charges if the creditor is oversecured and the charges are reasonable); *In re 139-141 Owners Corp.*, 2004 U.S. Dist. LEXIS 16576 (S.D.N.Y. Aug. 13, 2004), at \*12 ("the balance of the equities favored awarding [the lender] he contractual interest rate"); *Greenwood Trust Co. v. Commonwealth of Massachusetts*,

971 F.2d 818, 825 (1<sup>st</sup> Cir. 1992) (holding that late charges are a form of interest, and that the State of Massachusetts could not bar an out-of-state bank from charging late-payment fees on delinquent credit-card accounts, and stating that “federal case law has long suggested that, in ordinary usage, interest may encompass late fees and kindred charges”); *Holmes v. Citigroup Investments Agrifinance (In re Holmes)*, 2005 Bankr. LEXIS 1302 (Bankr. M.D. Ga. July 1, 2005), at \*6 (“courts should be reluctant to infer a mechanism for disallowing default rates of interest under federal law. Rather, the allowability of the rate should turn instead on applicable nonbankruptcy law”); *Orix Credit Alliance CIT Group/Equipment Financing, Inc. (In re Hughes)*, 230 B.R. 213, 230 (Bankr. M.D. Ga. 1998) (holding that when creditor is oversecured, estate need not be solvent for creditor to be entitled to postpetition interest).

In *In re 139-141 Owners Corp.*, 306 B.R. 763 ((Bankr. S.D.N.Y. 2004), the bankruptcy court, citing prior authority in the Second Circuit (and in other jurisdictions), ruled that while in most circumstances it is within the court’s equitable power to limit or prevent the collection of the contractual default rate by the mortgagee in order to provide an “equitable distribution” to creditors, this is not a statutory right and is inappropriate and inequitable, and therefore should not be invoked, where the debtor is solvent and the rights of unsecured creditors are not adversely affected. The bankruptcy court cited the Second Circuit’s prior ruling in *Ruskin v. Griffiths*, 269 F.2d 827 (2<sup>nd</sup> Cir. 1959), *cert. denied*, 361 U.S. 947 (1960) which enforced the creditor’s right to the contractual default interest rate where the debtor was solvent. The court in *139-141 Owners Corp.* stated that, “*Ruskin* remains effective to date in the Second Circuit and is recognized by other circuits,” *Id.* at 771, and cited numerous decisions upholding the creditor’s right to contractual default interest where there were no countervailing equitable considerations. The court found that in this case the equities did not warrant the exercise of the court’s equitable discretion to nullify the creditor’s contractual right to collect default interest, for the following reasons: the debtor was solvent at all times, (the value of the debtor’s assets was more than twice its liabilities); its income was more than sufficient to pay its obligations as they became due, including debt service on both the first mortgage and second mortgage in effect on the property; the debtor defaulted in the payment of both mortgages for the sole purpose of diverting income to pay for the debtor’s other business ventures; the debtor did not file its bankruptcy proceeding to become profitable, to protect other creditors, or to prevent a foreclosure sale that would wipe out equity in the property; and any prohibition of the creditor’s right to collect interest at the stated default rate would be of sole benefit to the debtor and would create an unwarranted windfall. See also 4 A. Resnick and H. Sommer, *Collier on Bankruptcy* P506.04[2][b][ii] at 506-112 (15<sup>th</sup> rev. ed. 2004 (“in general a default rate of interest is properly a form of interest”); Melanie Rovner Cohen, Jeff J. Marwell, and Richard A. Gerard, *Entitlement of Secured Creditors to Default Interest Rates Under Bankruptcy Code Sections 506(b) and 1124*, 45 BUS. LAW. 415 (1989); Annot., *Validity and Construction of Provision Imposing “Late Charge” or Similar Exaction for Delay in Making Periodic Payments on Note, Mortgage, or Instalment Sale Contract*, 63 A.L.R.3d 50, § 5 (1975); *Foreclosure: New Jersey High Court Upholds Late Charges*, 29-OCT Real Est. L. Rep. 8 (1999); Harris Ominsky and Stuart D. Poppel, *Loans: Late Charges Challenged*, 116 Banking L.J. 4 (1999).

Sec. 365 (b)(2)(D) of the Bankruptcy Code states that, with respect to the trustee's option to assume a lease or other executory contract entered into by the debtor by curing any defaults, the trustee's obligation to cure such default is inapplicable if the default is a breach of a provision relating to "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease." This particular language has created an ambiguity that remains unresolved by the courts: Does the word "penalty" modify "rate," or "rate and provision"? This distinction is important because the sentence structure "raise[s] a question as to whether or not the exception is for penalty rates and provisions for non-monetary defaults only, or whether the intent was 'penalty' rates for monetary defaults, and penalty provisions for non-monetary defaults." Bruce H. White and William L. Medford, *Assumption of Executory Contracts and Curing Defaults: In the Interest of Penalties*, 2002 ABI JNL. LEXIS 155. If the language in § 365(b)(2)(D) constitutes an exception for non-monetary defaults only, the bankruptcy trustee would not be required to cure penalties imposed by default interest rates. The majority of cases hold that the trustee is not required to pay contractual penalty-interest rates or pay penalty provisions applicable to non-monetary defaults. See *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029, 1034 (9<sup>th</sup> Cir. 1997); *In re Walden Ridge Dev. LLC*, 292 B.R. 58, 67 & n.2 (Bankr. D.N.J. 2003); *In re Williams*, 299 B.R. 684, 686 (Bankr. S.D. Ga. 2003); *In re New Breed Realty Enters.*, 278 B.R. 314, 320 (Bankr. E.D.N.Y. 2002); *In re Vitanza*, 1998 Bankr. LEXIS 1497, at \*21 n.44 (Bankr. E.D. Pa. Nov. 13, 1998); Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 Am. Bankr. L.J. 551, 558 (1995) (arguing that Bankruptcy Code does not require default or penalty rate to be paid when plan reverses acceleration and reinstates terms of an obligation); cf. *In re Bankvest Capital Corp.*, 360 F.3d 291, 298 (1<sup>st</sup> Cir. 2004) (stating that, "the legislative history of § 365(b)(2)(D) is not instructive" and "Congress intended § 365(b)(2)(D) to free debtors from lease provisions requiring the payment of penalty rates"). But these cases are not entirely clear as to whether a default interest rate is *per se* a prohibited penalty. Neither the Bankruptcy Code nor applicable case law defines "penalty." At least one case, *In re Phoenix Business Park Ltd. Partnership*, 257 B.R. 517 (Bankr. D. Ariz. 2001), indicates that a "penalty rate" means a rate that is punitive in nature and not merely a default rate that exceeds the contract rate. According to the court, "if a default interest rate is a 'penalty rate,' then it does not need to be paid as part of a . . . cure." *Id.* at 521. The court found that in this case the default rate of 24 percent (the contract rate was 10.75 percent), as well as monthly late charges of more than \$1000, should be construed as a "penalty rate[s]" within the meaning of § 365(b)(2)(D). *Id.* See also White and Medford, *supra*, stating that, "the exception provided in § 365(b)(2)(D) does not excuse any and all types of default provisions. Instead, § 365(b)(2)(D) excepts penalty provisions as public policy supports the non-payment of harsh, penalizing provisions." Other courts, however, contrary to the cases cited above, have held that the word "penalty" describes only the word "rate," and that the second half of subparagraph (2)(D) creates a separate exception for non-monetary defaults. See *In re Payless Cashways, Inc.*, 287 B.R. 482, 489 (Bankr. W.D. Mo. 2002) ("the plain language of Section 506(b) contains no authorization for the examination of the 'reasonableness' of the rate of interest charged by an oversecured creditor"). See also *In re Walden Ridge Dev. LLC*, 292 B.R. 58, 67 &

n.2 (Bankr. D.N.J. 2003); *In re Western Pac. Airlines*, 219 B.R. 298, 304 (Bankr. D. Colo.1998), *rev'd on other grounds*, 219 B.R. 305 (D. Colo. 1998); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 233-34 (Bankr. D. Neb. 1996). At least one commentary has argued that § 365(b)(2)(D) could be read, by negative implication, to require debtors to pay penalty rates occurring as the result of monetary defaults. See Grant T. Stein and Ralph S. Wheatly, *The Impact of Cure and Reinstatement on Default Interest*, 16 A.B.I. J. 1 (1997) (arguing that as policy matter, economic provisions of pre-confirmation contract, including default interest, should govern). See also *In re Bankfest, supra*, 360 F.3d. at 298 n.12 (“while that problem [discussed in the Stein and Wheatly article] does not bear directly on the dispute in this case, it does tend to reinforce our conclusion that the text of subparagraph (2)(D) is ambiguous”).

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“Act”), 2005 (P.L. 109-8), was enacted into law on April 20, 2005 and applies to all bankruptcy cases filed on or after October 17, 2005 (with limited exceptions as to certain provisions). Section 365(b)(2)(D) is amended to provide that § 365(b)(1) does not apply to a default under a provision relating to any penalty rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary lease obligations. It is now clear that, in accordance with the decisions of the majority of courts on this issue, the trustee is not required to pay contractual penalty-interest rates or pay penalty provisions applicable to non-monetary defaults.

## **Issues With Respect to Late Charges**

### **A. Late Charges as Interest**

Court decisions have split on whether the imposition of a late charge can be construed as interest under state law or federal common law. In *Greenwood Trust Co. v. Commonwealth of Massachusetts*, 971 F.2d 818 (1<sup>st</sup> Cir. 1992), the First Circuit Court of Appeals held that late charges are a form of interest, and that the State of Massachusetts could not bar an out-of-state bank from charging late-payment fees on delinquent credit-card accounts. The court first noted that “interest is often, but not always, expressed as a percentage.” *Id.* at 824. The court then stated that “federal case law has long suggested that, in ordinary usage, interest may encompass late fees and kindred charges.” *Id.* at 825. The court acknowledged that an additional fee attached to a delinquent account was related to the creditor’s cost of lending the money, but found that the late fee was sufficiently related to the “use or forbearance of money, or . . . damages for its detention” that it could appropriately be classified as interest. *Id.* at 825. The court also ruled that the result would be the same under federal common law, under which, according to the court, the term “interest” would include “a variety of lender-imposed fees and financial requirements which are independent of a numerical percentage rate.” *Id.* at 829. See also *Swindell v. Federal Nat’l Mortgage Ass’n*, 330 N.C. 153, 409 S.E.2d 892, 894-95 (1991) (under North Carolina law, late charges are a component of interest).

*But see Gadon v. Chase Manhattan Bank (USA)*, 439 Pa.Super. 210, 214, 653 A.2d 697, 699 (1995) (distinguishing *Greenwood Trust Co. v. Commonwealth of Massachusetts*, *supra*, and finding no authority for finding that late charges and contingent fees are included in calculating the overall interest rate charged to a loan under limits set by state law); *Mazaika v. Bank One Columbus, N.A.*, 439 Pa. Super. 95, 106, 653 A.2d 640, 645-46 (1994) (holding that late fees and other charges were subject to Pennsylvania's consumer protection and usury statutes); *Sherman v. Citibank South (South Dakota), N.A.*, 143 N.J. 35, 95, 668 A.2d 1036, 1061 (1995) (ruing that "interest for most favored lender doctrine under the National Bank Act does not include late charges); *Perry v. Stewart Title Co.*, 756 F.2d 1197, 1207-08 (5<sup>th</sup> Cir. 1985) (under Texas law, late charges are not a component of interest); 815 ILCS 205/4.1a (excluding from the calculation of interest on a loan a charge provided in the agreement, for each loan installment in default for a period of not less than 10 days, in an amount not in excess of 5% of such loan installment).

## B. Late Charges as Penalties

Under Illinois law, a late charge provided for in the note evidencing a mortgage loan may be deemed to be an unenforceable penalty. See *Garcia v. Canan*, 851 F.Supp. 327, 328-29 (N.D. Ill. 1994) (holding that late charge based on 10 percent of unpaid installments, regardless of how many days borrower was delinquent, was penalty and not liquidated damages); *AT&T Capital Leasing Services, Inc. v. Brasch*, 912 F.Supp. 395, 397 (N.D. Ill. 1996) (upholding defendant's claim that, under Illinois law, 10% late penalty was unenforceable penalty and stating that Illinois "imposes that prohibition as a matter of public policy, which overrides any possible entitlement to such penalties derived from any other source"); *Whirlpool Financial Corp. v. Sevaux*, 1995 U.S. Dist. LEXIS 14199 (N.D. Ill.), at \*5 ("there is no reasonable relation between the 5% flat charge imposed upon every payment that was due, including matured principal, and damages suffered or likely to be suffered as a result of [the borrower's] delinquency. The Court finds that the late charges are penalties, and are thus, unenforceable"); *In re AE Hotel Venture*, *supra* (stating that where creditor will be paid late charges under loan documents, it cannot also claim default interest under § 506(b) of the Bankruptcy Code, "because payment of both would amount to a double recovery").

## C. Waiver of Late Payments

There is also authority for the proposition that a lender that consistently accepts late payments from a debtor has a duty to notify the debtor before it begins strict enforcement of its contractual rights. In *Mercedes-Benz Credit Corp. v. Morgan*, 312 Ark. 225, 850 S.W.2d 297 (Ark. Sup. Ct. 1993), the lender accepted late payments over the course of a year, then decided to exercise its right under the contract and state law to the self-help remedy of repossession. The borrower sued the lender for conversion after the lender seized the automobile collateral. The court ruled that the creditor's routine acceptance of delinquent payments waived strict compliance with the parties' contractual payment and enforcement provisions absent notice that strict compliance would be expected.

#### D. Late Charges After Acceleration

If the mortgagee accelerates the loan balance following a series of unpaid monthly installments, can the mortgagee impose late charges for nonpayments following acceleration of the loan balance? Almost all courts that have decided this issue have held that a lender may not impose a late fee, payable upon late payment of a loan installment, on the entire accelerated principal loan balance. In *Security Mutual Life Ins. Co. of New York v. Contemporary Real Estate Associates*, 979 F.2d 329 (3rd Cir. 1992), the court ruled the mortgagee could not impose late charges after accelerating the loan balance following a series of unpaid monthly installments, at least in the absence of a specific provision in the mortgage. The court concluded that no Pennsylvania court had yet decided whether late fees could be imposed upon a debtor for failure to make monthly payments on a note after that note has been accelerated. Therefore, it held that it must predict how the Supreme Court of Pennsylvania would determine that issue. The court also considered that few other courts in other jurisdictions had rendered published opinions on this issue either, but that the courts that had decided the issue had held that such late charges cannot be assessed against a borrower after a lender has accelerated payment of the note. The court reasoned that acceleration obligates the mortgagor to pay the entire debt, and therefore eliminates the requirement of monthly installments. The court also noted that equity does not favor the inclusion of late charges, because the judgment included prejudgment interest at the annual contract rate of 12.25 percent. Finally, the court rejected the argument of the mortgagee that the mortgagor could have avoided the payment of the late charges by making a monthly payment notwithstanding the acceleration of the note -- construing, in effect, the remedies of late charges and loan acceleration as parallel remedies rather than alternative ones -- on logical grounds and because there is legal authority (see *Mercedes-Benz Corp. v Morgan, supra*) that holds that the acceptance of late payments after acceleration may constitute a waiver of a prior default. See also *Green Point Sav. Bank v. Varana*, 653 N.Y.S. 2d 656, 657 (N.Y. App. Div., Second Dept. 1997) ("at least in the absence of a provision providing otherwise, which is not present in the mortgage documents involved here, late charges for nonpayment of installments claimed to be due after acceleration cannot be collected"); *In re LHD Realty Corp.*, 726 F.2d 327, 333 (7th Cir. 1984) (court looks initially to federal bankruptcy standards, but state law is dispositive with respect to imposition of late charges, and they will not be permitted after acceleration; court reinstated pre-acceleration late charges on appeal); *In re Tavern Motor Inn, Inc.*, 69 B.R. 138, 141-42 (Bankr. D.Vt. 1986) (holding that mortgagee could not accelerate mortgage and deny debtor the right to make monthly installment payments under the note while continuing to insist on its own right under the note to impose monthly late charges, and thus, mortgagee was not permitted under the note to provide for late charges after loan had been accelerated and entire balance of debt was due); *In re Tampa Chain Co, Inc.*, 53 B.R. 772, 781-82 (Bankr. S.D.N.Y. 1985) (prohibiting mortgagee from enforcing provision in note providing that post-maturity interest would accrue and be payable at the rate of two percent per month on each installment not paid when due); *Whirlpool Financial Corp. v. Sevaux*, 1995 U.S. Dist. LEXIS 14199 (N.D. Ill.), at \*5 ("there is no reasonable relation between the 5% flat charge imposed upon every payment that was due, including matured principal, and

damages suffered or likely to be suffered as a result of [the borrower's] delinquency. The Court finds that the late charges are penalties, and are thus unenforceable"); *Crest Savings & Loan Ass'n v. Mason*, 243 N.J. Super. 646, 649 (Ch. Div. 1990) (ruling that late charges cannot be assessed against a borrower for nonpayment of installments after a lender has accelerated payment of the note); *Reis v. Decker*, 516 N.Y.S.2d 851 (Del. Co. Ct. 1987) ("[t]he purpose of late charges is to compensate a creditor for the expense and inconvenience of collecting installments. Such charges are proper and recoverable when actions to recover installments which are due and unpaid, but are not recoverable in a foreclosure proceeding whereat one seeks to recover a full accelerated principal debt"); *Centerbank v. D'Assaro*, 600 N.Y.S.2d 1015, 1017 (1993) (stating that "defendant's obligation to pay late charges ceased with installments due and payable at the time of service of the summons and complaint," and that it is "inconsistent to allow a lending institution to accelerate a note, thereby denying the debtor the right under the mortgage to make monthly installments" and still charge a late fee); *Duda v. Thompson*, 647 N.Y.S. 2d 401, 403 (Westchester Co. Ct. 1996) (holding, in context of lease default, that late charges due for unpaid installments would not be allowed after date that notice of acceleration was served on lessee); *In re Brunswick Apartments of Trumbull, Ltd.*, 169 F.3d 333, 335 (6<sup>th</sup> Cir. 1999) (ruling that late fee was unreasonable when applied to entire unpaid balance of mortgage loan); *In re White, supra*, 88 B.R. at 505 (late charges allowed only until acceleration); *Rizzo v. Pierce & Associates*, 351 F.3d 791, 793 n.1 (7<sup>th</sup> Cir. 2004) (citing sixteen cases for proposition that post-acceleration late charges are unenforceable); *Wells Fargo Bank Minnesota N.A. v. Guarnieri*, 308 B.R. 122, 127 (D. Conn. 2004) (post-acceleration late-payment charges unenforceable); *TMG Life Ins. Co. v. Ashner*, 21 Kan. App. 2d 234, 256 (holding that late fees serve limited purpose of compensating lenders "for administration of late payments prior to acceleration (emphasis added)"); *LaSalle Bank Nat'l Ass'n v. Shepherd Mall Ptnrs, L.L.C.*, 2006 OK Civ. App. 91 (Okla. Ct. App. 2005), P11, P16 (stating that "the right to charge late fees ceases upon acceleration because monthly payments are not due after acceleration, so the lender no longer incurs expenses in processing delinquent payments," and finding post-acceleration late fee of \$1,375,000 "clearly excessive" under liquidated-damages analysis).

As indicated in a few of the cases cited above, courts occasionally may permit the lender to collect late charges on accelerated loan balances when the mortgage loan documents expressly provide for such fees upon acceleration of the debt. See, e.g., *In re O'Neill*, 204 B.R. 881, 88 (Bankr. E.D. Pa. 1997) (holding that, where mortgage note was not introduced into evidence, court could not determine whether late charges were permitted after declaration of default by lender, and post-judgment late charges assessed by lender would be permitted because debtor had failed to meet his burden of demonstrating that the imposition of such fees was precluded); *Orix Credit Alliance, Inc. v. Bell Realty, Inc.*, 1995 U.S. Dist. LEXIS 12255 (S.D.N.Y. August 23, 1995) ("the Note unequivocally provides for the imposition of late charges after default and acceleration. There can be no legal or factual dispute that under the terms of this Note that late charges may be imposed after acceleration"). See generally Annot., *Validity and Construction of Provision Imposing 'Late Charge' or*

*Similar Exaction for Delay in Making Periodic Payments on Note, Mortgage, or Installment Sale Contract*, 63 A.L.R. 3d 50, supp. sec. 8.

#### E. Amounts Subject to Late Charges

The mortgage documents should clearly state the amounts that will be subjected to late charges. In *Ford v. Dovenmuehle Mortgage, Inc.*, 273 Ill.App.3d 240, 651 N.E.2d 751 (1995), the term "installment" in the promissory note, which evidenced an indebtedness only for the principal sum and interest payable on the unpaid balance, referred to "principal and interest" and did not include taxes and insurance. The court held that the term "installment" was not ambiguous, and that the mortgagee could impose late charges based on "installment" consisting of principal, interest, taxes, and insurance, rather than merely principal and interest. The court noted that "the term installment was not expressly defined or limited to exclusively mean principal and interest only" and that "it would be nonsensical to include within that term in this early section of the documents a reference to taxes and hazard insurance since those referents had not yet been identified as debt obligations of the mortgagor." *Id.*, 273 Ill.App.3d at 246, 651 N.E.2d at 756. See also *Moore v. Lomas Mortgage USA*, 796 F.Supp. 300, 3 (1992) (holding that where the word "installment" was modified by the words "principal and interest" at one place in the loan documents, but stood alone in the late charge provision, such modifying language would have been rendered superfluous if "installment" meant principal and interest throughout the mortgage; the court ruled that the mortgage service company's practice of calculating late charges on principal, interest, taxes and insurance did not violate the Illinois Consumer Fraud Act and that the mortgagors' contracts authorized the calculation of late charges on such amounts); *In re Christian*, 35 B.R. 229, 232 (Bankr. Ga. 1983) (holding that in order to cure and reinstate the loan, the debtor was required to pay a late charge of four percent on any monthly installment not received within the appropriate time, as set forth in the loan documents).

#### Exit Fees

In recent years, mortgage lenders have inserted clauses in their loan documents requiring "exit fees" in lieu of traditional prepayment premiums (often in connection with securitized loans and mezzanine financing). These charges are imposed as a means of extracting an additional fee or charge from the mortgagor for early repayment of the loan and are also due upon the maturity date (whether voluntary or involuntary) of the loan. Such fees are often charged in connection with short-term financing, i.e., loans with a term of three to five years. It is unclear whether courts will construe these charges as additional interest, a "prepayment penalty," or as some other fee or charge. It is also unclear whether "exit fee" provisions will be deemed "reasonable" under either state law or under § 506(b) of the Bankruptcy Code, or whether courts will subject them to a liquidated-damages analysis or declare them to be unenforceable penalties.

In a case of first impression, *Delta Rault Energy 110 Veterans L.L.C.*, 2004 U.S. Dist. LEXIS 15136 (E.D. La. August 4, 2004), the court held that a provision in a short-term mortgage loan for an "exit fee" payable upon acceleration for any reason, whether by maturity of the loan or prepayment, was valid and enforceable when the borrower prepaid the loan in connection with a refinancing. This is the first case coming down squarely in favor of rendering an "exit fee" enforceable as an additional loan charge (of some sort) and (somewhat surprisingly) not construing it as a prepayment premium or penalty or subjecting it to a liquidated-damages analysis. The court found that the exit fee was "an additional fee or deferred interest added as consideration for defendant making the loan," and that because it was clear and ambiguous parol evidence was not admissible as to the parties' intent.

See also *In re American Metals Corp.*, 31 B.R. 229, 236-37 (Bankr. D. Kansas 1983). In this case the court found -- also in a case of first impression -- that a "termination charge" as provided for in the security agreement, which was payable upon early termination of the agreement by the debtor, was in the nature of a penalty rather than a true liquidated-damages clause and was not allowable as part of creditor's secured claim. This case did not involve a mortgage, and the lender's "first, prior and duly perfected" security interest covered all the debtor's assets, including accounts receivable, equipment, inventory, and all proceeds of the collateral. According to the court, the termination provision in the security agreement provided that if the borrower elected to terminate the agreement prior to the end of the original term (or prior to the end of any subsequent extended term), "[Lender] is entitled to a termination charge of \$20,000 times the number of remaining months in the term of the agreement, including the month of termination." *Id.* at 236. The lender contended that the fee was allowable under sec. 506(b) of the Bankruptcy Code as a "reasonable fee, cost or charge." The court acknowledged that "research disclosed no case . . . resolving the issue herein of the allowability of a termination charge," and that the legislative history of sec. 506(b) did not provide any guidance on the issue of what "fees, costs or charges" are allowable. *Id.* at 237. Interestingly, the court noted that the borrower had argued that enforcing the termination clause would violate sec. 365 of the Bankruptcy Code, which invalidates "ipso facto" bankruptcy clauses in executory contracts. But the court dismissed this argument, holding that such invalidation does not apply, under sec. 365(e)(2)(B), to contracts to lend money to the debtor. *Id.* at 237 n.3. The court found that, under the facts of this case, the termination-charge clause was a penalty rather than a liquidated-damages clause, because it was not reasonable or proportionate to the loss the lender would suffer and because the "collateral was equipment and accounts receivable, more susceptible to appraisal and more marketable in a liquidation sale." *Id.* at 237. According to the court, "sec. 506(b) is limited to actual costs, charges or damages," and since it "is an extraordinary remedy for oversecured creditors . . . it should not be read so broadly as to allow all purported expenses, whether actual, estimated or illusory." *Id.* But the court was careful to point out that this "is not to say that a liquidated damages clause should not be given credence in allowing costs or damages under sec. 506(b)." *Id.* Thus, the court appears to leave the door open for the enforcement of "unusual" fees and costs (such as exit fees), which would be judged on a case-by-case basis under a liquidated-damages analysis -- and may well be deemed

to be appropriate and enforceable where the evidence supports a finding that the factors necessary to uphold the validity of a liquidated-damages provision are present.

The court in the *Delta Rault* case, *supra*, noted that the exit fee provision was clear and unambiguous and was specifically negotiated by sophisticated parties as consideration for the loan. Thus it also may be prudent for lenders to make certain that the exit-fee (or similar) provision states that the clause has been executed by sophisticated parties as specifically bargained-for additional consideration for the loan; that the borrower has been advised by counsel of its choice as to the scope and enforceability of the provision; and that the parties acknowledge that it would be difficult to calculate the lender's actual damages upon the occurrence of any of the "triggering" events set forth in the clause. It may even be a good idea to bold and capitalize the provision.

In *In re Maywood, Inc.*, 210 B.R. 91 (Bankr. N.D. Tex. 1997), the court refused to allow the lender's claim for an "Early Termination Fee" as set forth in the Loan Agreement with the debtor-borrower. The court stated that, "When acceleration of a loan is triggered by the lender, Illinois law does not enforce termination fees (citation omitted). . . . It is not customary in Chapter 7 cases for courts to award termination fees even though a contract may provide for them (citations omitted)." *Id.* at 94. The court in this case found that, based on the equities of the case and the fact that the mortgagee had failed to show any evidence of damages as the result of its decision to accelerate the loan, the early termination fee was not reasonable under § 506(b) of the Bankruptcy Code and would be disallowed.

Attached hereto, as **Appendix A** and **Appendix B**, are sample forms of "exit fee" provisions for insertion in a commercial mortgage-loan note. See, *generally*, John C. Murray, *Enforceability of Prepayment-Premium Provisions in Commercial Loan Documents*, 442 PLI/Real 263, 288 (1999).

### **Other Types of Fees and Charges**

Several other court decisions have dealt with the issue of whether certain other fees and charges, such as amounts charged for or in connection with loan payoff statements, are "prepayment penalties" under mortgage notes. Generally, these cases have held that certain fees charged by the mortgagee in connection with a mortgage payoff request, e.g., the mortgagee's quote fee of \$15 for requesting more than one written payoff statement and \$10 for facsimile transmissions of the payoff statement, were not "prepayment charges" within the meaning of residential mortgages and promissory notes prohibiting prepayment charges. These courts reason that such fax and quote fees could be charged for reasons other than prepayment, that a mortgagor does not necessarily need to obtain a payoff statement to prepay a mortgage loan, and that these service charges are not incurred only when a mortgagor is paying a loan before its maturity date. These courts have also found that fax and statement fees are actually charges for special services outside of the basic service agreement

provided to the borrower by the lender with respect to -- but not exclusively related to -- the prepayment of a loan.

### **Conclusion**

To ensure their enforceability, counsel for mortgage lenders must carefully draft provisions in mortgage loan documents providing for the imposition of additional interest, as well as charges and fees for loan defaults or late payments. The same admonition applies to prepayment premiums and exit fees triggered by early payment of the debt or payment of the loan at maturity. As noted in this article, court decisions have not been consistent regarding the validity and enforceability of these provisions. Counsel would be well advised to provide a “cap” on such fees that is within the “safe” range as established by relevant case (or statutory) law in the applicable jurisdiction.

## Appendix A

### EXIT FEE (NOTE)

**"Exit Fee"** shall mean the sum of %\_\_\_\_\_ in the first Loan Year and the Second Loan Year and \$\_\_\_\_\_ in the Third Loan Year. Upon the repayment in full of the Loan, whether on the Maturity Date, upon payment of the Loan as permitted by **Section** \_\_\_\_\_ of this Note or upon the acceleration of the Loan by Lender following an Event of Default, Borrower shall pay to Lender, together with all other amounts due or payable under this Note or the other Loan Documents, the Exit Fee.

## Appendix B

### ALTERNATIVE EXIT FEE PROVISION (NOTE)

As a material inducement to fund the Loan, Maker shall pay to Holder a fee (the “**Additional Fee**”) on the first to occur of (i) the Maturity Date (as the same may be accelerated following an Event of Default) or (ii) a refinancing of the Senior Loan (as defined in the Loan Agreement) other than a refinancing of the Senior Loan with a construction loan to which Holder subordinates pursuant to the terms of the Loan Agreement. The Additional Fee, which shall be deemed earned as of the funding of the Loan, shall equal the sum of (i) \$\_\_\_\_\_ for every percentage point (or portion thereof) in excess of \_\_\_\_\_ percent (\_\_\_%) of FAR (as defined in the Loan Agreement) for which Maker receives all necessary approvals for redevelopment of the Real Property, not to exceed \$\_\_\_\_\_ in the aggregate, and (ii) \$\_\_\_\_\_; provided, however, that if Maker elects to exercise the extension option set forth in Section \_\_\_ hereof, then upon such exercise the amount in clause (ii) of this sentence shall be \$\_\_\_\_\_. Notwithstanding the foregoing, if Maker pays in full all of the Obligations (including all accrued and unpaid interest, all outstanding principal, and the Additional Fee) prior to \_\_\_\_\_, 200\_\_, then the Additional Fee shall equal the sum of (x) \$\_\_\_\_\_ for every percentage point (or portion thereof) in excess of \_\_\_\_\_ percent (\_\_\_%) of FAR for which Maker receives all necessary approvals for redevelopment of the Real Property, not to exceed \$\_\_\_\_\_ in the aggregate, and (xi) \$\_\_\_\_\_. The payments described in clauses (i) and (x) of this Section \_\_\_ are referred to herein as the “**FAR Increment.**” On the date of payment of the Additional Fee, the Additional Fee shall be calculated on the basis of the FAR for which Maker shall have then received all necessary approvals; provided, however, if additional FAR (FAR in excess of the approved FAR as of the date of the payment of the Additional Fee) is approved at any time within the two (2) years following the payment of the Additional Fee, then immediately upon receipt of such approval, Maker shall pay to Holder the FAR Increment with respect to such additional FAR. The FAR Increment for such additional FAR shall be determined pursuant to clause (i) or (x) based on the date of payment of same (irrespective of the date of payment of the other portions of the Additional Fee). Maker’s obligation to pay the FAR Increment with respect to FAR approved after the date of repayment of the other Obligations shall survive the repayment of all other amounts due under the Loan Documents and shall be secured in accordance with Section \_\_\_ of the Loan Agreement.