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THE ENFORCEABILITY OF DEFAULT INTEREST IN REAL ESTATE MORTGAGES

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Editors' Synopsis: This Article examines the use of default interest rate provisions in real estate mortgage loan transactions and the varying ways courts assess the enforceability of such provisions. The authors argue that these provisions are important to lenders, ensuring that they are able to recover the transaction costs and risks associated with defaulting borrowers. The Article asserts that, due to the importance of these provisions to lenders' financial stability, courts should apply the unconscionability standard with a deference to freedom of contract principles before refusing to enforce default interest rate provisions. The authors also outline guidelines lenders should follow in both drafting loan agreements containing these provisions and defending against challenges to the imposition of default interest rates.

In both residential and commercial real estate mortgage loan transactions, if the borrower fails to make a debt-service payment in a timely manner, often the terms of the loan will require the borrower to pay late charges expressed as a fixed dollar amount or as a percentage of the

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missed installment.[1] The loan documents also may require the borrower to pay a higher default interest rate during default and perhaps even after the default is cured.[2] Typically, once the debt is accelerated after default, the late charges stop, but interest continues to accrue at the default rate on the accelerated loan balance.[3]

Outside of bankruptcy, courts traditionally have enforced default interest provisions under freedom of contract principles.[4] Courts have struck down these provisions only when the borrower has met the strict standards of the unconscionability doctrine, as distinguished from the less

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[1] Often the late fee is expressed both in terms of a fixed dollar amount and as a percentage. For example, 5% of the late installment or $100, whichever is greater (or less).

[2] Query whether a contract provision that imposes the default rate after the default is cured is contrary to the policy behind some states' reinstatement or arrearage laws, which allow the debtor to cure the default and decelerate the loan prior to the foreclosure sale.

[3] Courts tend to reject the imposition of late fees after acceleration of the loan, either by interpreting the late fee provision as inapplicable on acceleration or by finding such imposition unenforceable as a penalty. *See, e.g.*, LaSalle Bank Nat'l Ass'n v. Shepherd Mall Partners, L.L.C., 140 P.3d 559 (Okla. Civ. App. 2006) (holding that application of 5% late fee to entire accelerated balance is an unenforceable penalty). Related to cases refusing to invoke a late fee following acceleration are those denying late fees after initiation of foreclosure, *see* Centerbank v. D'Assaro, 600 N.Y.S.2d 1015 (N.Y. Sup. Ct. 1993), and those refusing to allow a late charge on a tardy balloon payment, *see, e.g.*, Poseidon Dev., Inc. v. Woodland Lane Estates, L.L.C., 62 Cal. Rptr. 3d 59 (Cal. Ct. App. 2007) (interpreting note's plain language to deny late fee on balloon payment; if 10% late fee had been intended to apply to balloon payment, it would have been an unenforceable penalty); Art Country Squire, L.L.C. v. Inland Mortgage Corp., 745 N.E.2d 885 (Ind. Ct. App. 2001) (holding that, as matter of contract interpretation, late fee did not apply to balloon payment).

[4] *See* Smiley v. Manufactured Hous. Assoc. III Ltd. P'ship, 679 So. 2d 1229 (Fla. Dist. Ct. App. 1996) (finding trial court without authority to refuse to enforce default rate not to exceed 18%; contract rate was 8.5%); Chem. Bank v. Am. Nat'l Bank & Trust Co. of Chi., 535 N.E.2d 940 (Ill. App. Ct. 1989) (seeing no reason to relieve sophisticated borrower from agreed upon default rate). In addition to common law regulation, federal and some state statutes regulate the collection of default interest for certain consumer mortgage transactions. *See, e.g.*, 15 U.S.C. § 1639(d) (2000) (prohibiting default interest higher than the contract rate in nonpurchase-money mortgage loans that are high-cost, defined as having an annual rate exceeding the Treasury yield by more than 10% or having total points or fees due at closing exceeding 8% of the loan or $400. States such as Arkansas, Colorado, Florida, Georgia, Massachusetts, New Jersey, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, and Tennessee have similar restrictions for high cost home loans. Louisiana is one of the few states that regulate default rates of commercial loans. *See* LA. REV. STAT. ANN. § 9:3509 (West 1997) (capping default rate based on loan amount, for example, at the greater of 18% or three percentage points over the contract rate, for loans with an original principal balance of $250,000 or less).

stringent test under a liquidated damages versus penalty analysis, or so-called reasonableness standard. This unconscionability analysis is consistent with the judicial standards courts have applied to challenges to other loan charges, such as fees for prepayment of loans.[5] However, some courts have begun applying a reasonableness standard to govern the enforceability of default interest charges.[6] This Article articulates the theoretical and practical arguments favoring the unconscionability standard and suggests that courts applying the reasonableness standard should nonetheless give the lender appropriate latitude for these provisions. This analysis is timely—against the backdrop of the so-called mortgage meltdown of 2008, more courts may have occasion to consider the appropriate standards for enforceability of default interest.

I. NATURE AND PURPOSE OF DEFAULT INTEREST

The standard note for both residential and commercial real estate mortgage loans contains provisions designed to ensure that the mortgage lender will receive a designated amount of interest income over a designated period of time and a return of its debt capital once the loan matures. A default interest provision that requires the borrower to pay an increased interest rate should the borrower default in making a monthly debt-service payment or otherwise default under the terms of the note, mortgage, or both, is fundamental to protecting mortgage lenders' expectations. Such default interest provisions are designed to compensate the lender for a

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[5] *See, e.g.*, Lazzareschi Inv. Co. v. S.F. Fed. Sav. & Loan Ass'n, 99 Cal. Rptr. 417 (Cal. Ct. App. 1971) (upholding a prepayment fee even though the interest rate was substantially less than the lender could have earned by lending the recaptured funds to someone else). The litmus test for enforceability, in the opinion of the court, was not whether the prepayment charge was an unreasonable penalty, such as under a liquidated damages versus penalty analysis, but whether the charge was "palpably exorbitant." *Id.* at 240. *See generally* MICHAEL T. MADISON, JEFFRY R. DWYER & STEVEN W. BENDER, THE LAW OF REAL ESTATE FINANCING § 5:35 (rev. ed. 2004). But if the court confronts a prepayment clause that operates more like a late fee, the court may be inclined to apply the less rigorous reasonableness standard. For example, in *Ridgley v. Topa Thrift & Loan Ass'n*, 953 P.2d 484 (Cal. 1998), the California Supreme Court encountered a clause in the mortgage note that imposed a charge of six months' interest if the borrower prepaid the loan and had made a prior late payment or otherwise defaulted under the loan. Treating this clause as a late payment fee, to which the court applied the standard of reasonableness, rather than as a prepayment charge, to which the exorbitance or unconscionability standard would apply, the court viewed the clause as an unenforceable penalty for default.

[6] *See* Art Country Squire, L.L.C. v. Inland Mortgage Corp., 745 N.E.2d 885 (Ind. Ct. App. 2001); MetLife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P., 732 A.2d 493 (N.J. 1999).

wide range of losses and risks, both those flowing from the particular defaulted loan and borrower and those from the pool of defaulted loans that the borrower has joined. Among other things, these losses include: the loss of regular contract interest income during the term of the loan; the opportunity costs of foregoing other investments during the default period; the need for regulated lenders to place additional money on reserve based on defaulted loans in their portfolio (which diverts money from income-producing investments);[7] the possibility that the negative impact of a nonperforming loan on the lender's balance sheet could cause regulatory problems and make obtaining funding in the credit markets more expensive; and the additional internal administrative costs the lender must incur to monitor and otherwise deal with a defaulted loan.

Historically, mortgage lenders rarely are made whole by foreclosure sales. To illustrate, a well-grounded empirical study conducted by a nationally known real estate scholar, analyzed 448 real estate foreclosures in Illinois. Her study revealed that, in most cases, the only bidder at the sale was the foreclosing mortgagee.[8] In addition, in roughly 90 percent of the cases the value of the property did not exceed the amount of the debt secured by the property plus the typical costs to carry and resell the property.[9]

It being self-evident that lenders are not made whole again by foreclosure sales, why would a borrower allow the mortgaged property to go to foreclosure if the property were worth more than the mortgage balance and the borrower had a meaningful amount of equity in the property? In such cases, common sense dictates that the borrower would either file for bankruptcy to stave off the foreclosure sale or, in the alternative, simply attempt to sell the property for an amount that exceeds the outstanding balance of the loan.[10] Additionally, in those jurisdictions that allow lenders to seek any shortfall, only a small number of deficiency judgments are collected by mortgage lenders.[11] According to one study, the overall net

[7] *See* HARRIS OMINSKY, REAL ESTATE LORE: MODERN TECHNIQUES AND EVERYDAY TIPS FOR THE PRACTITIONER 67 (2006).

[8] *See* Debra P. Stark, *Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform*, 30 U. MICH. J.L. REFORM 639, 663 (1997).

[9] The study also found the typical carrying and resale costs to the lender were about 10% of the final judgment amount. *See id.* at 661.

[10] Rather than purchase at the foreclosure sale where there is little or no opportunity to perform due diligence on the property without the owner's cooperation, many distressed property purchasers seek out the borrower before the scheduled sale date and attempt to negotiate a sale involving a presale redemption of the loan.

[11] *See* William C. Prather, *A Realistic Approach to Foreclosure*, 14 BUS. LAW. 132,

loss recovery for all reported commercial mortgage foreclosures from 1986 through 1995 was only approximately 69 percent.[12]

In addition to assuming the risk of losing its debt capital, a foreclosing lender must assume the risk of loss based on the expenses and costs associated with the foreclosure process. According to a 2004 Freddie Mac study, the full foreclosure process is estimated to cost a lender an average of $58,792 and take 18 months to resolve.[13] Although the promissory note calls for reimbursement of collection expenses and reasonable attorneys' fees, this provision does not readily encompass the lender's own internal costs in collecting the debt. These costs include engaging and monitoring legal counsel, reviewing reports obtained in connection with the foreclosure (such as a property condition report and an appraisal), monitoring property insurance coverage, ensuring payment of real estate taxes, complying with discovery requests in a judicial foreclosure proceeding, and otherwise participating in any foreclosure action as well as defending against any challenges to the lender's rights and remedies pursued by the borrower. In addition, state or federal regulatory agencies, such as the state banking department, sometimes require the lender to undertake an analysis of the defaulted loan to assess its options, such as selling the delinquent mortgage or foreclosure.[14] Should the mortgagee obtain title in the foreclosure sale, as is typical, the lender faces holding costs (property maintenance,[15] insurance, taxes, assessments, and utilities); resale transaction costs, such as a broker's commission; and the internal administrative costs associated with the time involved in undertaking and monitoring these tasks. Presumably, these internal costs in the foreclosure cycle must take into account not only the salary and benefits of the lender's employees, but also the overhead costs of office space and office-related expenses.

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135 (1958).

12 *See* Brian A. Ciochetti, *Loss Characteristics of Commercial Mortgage Foreclosures*, 13 REAL EST. FIN. 53, 54 (1997).

13 *See* Amy Crews Cutts & Richard K. Green, INNOVATIVE SERVICING TECHNOLOGY: SMART ENOUGH TO KEEP PEOPLE IN THEIR HOUSES? 16 (Freddie Mac, Working Paper No. 04-03, 2004) (citing Craig Focardi, SERVICING DEFAULT MANAGEMENT: AN OVERVIEW OF THE PROCESS AND UNDERLYING TECHNOLOGY (TowerGroup Research Note No. 033-13C, Nov. 15, 2002)).

14 *See* OMINSKY, *supra* note 7, at 68.

15 One court recently ruled that a lender who purchased property at a judicial sale had a duty to exercise care to prevent a fire that damaged adjoining property, even when the court had not yet confirmed the foreclosure sale. *See* O'Connell v. ABN AMRO Mortgage Group, Inc., No. 2006-CA-000327-MR, 2007 WL 867632, at *2 (Ky. Ct. App. Mar. 23, 2007).

Moreover, some lenders have special workout or distressed loan departments that handle loans in default. Presumably all the salary and overhead costs of these groups are fairly allocated to delinquent loans by means of late fees and default interest rates.[16] And some loans, once securitized and serviced on behalf of the security holders, might see the servicing function transferred to a special servicer after default with a higher fee structure.[17]

II. ENFORCEABILITY UNDER THE UNCONSCIONABILITY STANDARD

In applying the unconscionability standard to curtail exorbitantly unfair terms in the loan contract, courts have drawn heavily on the Uniform Commercial Code's (UCC) articulation of unconscionability in the context of contracts for the sale of goods. Under the UCC, "[t]he basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract."[18] Most courts apply this unconscionability standard with deference to freedom of contract principles.[19]

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16 *See* OMINSKY, *supra* note 7, at 69.

17 *See id.* at 68.

18 UNIF. COMMERCIAL CODE § 2-302 cmt. 1 (2003), 1A U.L.A. 344 (2004). *See, e.g.*, Hamm v. Taylor, 429 A.2d 946, 948–49 (Conn. 1980) (insisting mortgage lender be afforded an opportunity to make a factual showing of the particular commercial circumstances that would justify a seemingly inequitable term in the mortgage or mortgage note, stating, "[f]inancial circumstances of the borrower, the increased risk associated with a second mortgage, and the income-producing capacity of the mortgaged property are some of the questions of fact that might appropriately be explored to shed light on whether a designated interest rate is or is not unconscionable."). The Kansas Supreme Court has listed ten factors relevant to an unconscionability determination. *See* Wille v. Sw. Bell Tel. Co., 549 P.2d 903, 906–07 (Kan. 1976). Colorado has listed seven of these factors. *See* Davis v. M.L.G. Corp., 712 P.2d 985, 991 (Colo. 1986).

19 *See, e.g.*, LaSalle Nat'l Bank v. Shook, No. 549266, 2000 WL 1513923, at *1 (Conn. Super. Ct. Sept. 27, 2000) (holding default interest rate enforceable as written because the payment of default interest was contractually agreed upon and the courts did not have the latitude to reject the agreement); Cantamar, L.L.C. v. Champagne,142 P.3d 140, 151 (Utah Ct. App. 2006) (holding that a 30% default rate was not unconscionable because "[a] party claiming unconscionability bears a heavy burden," and "[c]ourts will not 'assume the paternalistic role of declaring that one who has freely bound himself need not perform because the bargain is not favorable.'") (quoting Bekins Bar V Ranch v. Huth, 664 P.2d. 455, 459 (Utah 1983)).

Commentators have articulated the judicial standard for unconscionable terms as one demanding both oppression and unfair surprise.[20] Unfair surprise looks to unfairness in the bargaining process, whereas oppression explores the substantive unfairness of the contract terms. As summarized in the Calamari and Perillo treatise, substantive unconscionability focuses on the "content of the contract," as distinguished from procedural unconscionability, which focuses on the "process by which the allegedly offensive terms found their way into the agreement."[21] The late Professor Leff first observed and coined this distinction between what he colorfully termed "bargaining naughtiness" in the contract formation process (procedural unconscionability) and "evils in the resulting contract" (substantive unconscionability).[22]

In cases involving the loan transaction terms, typically a borrower attempts to demonstrate unfair surprise by pointing to a lack of knowledge of the unfair term, perhaps because the term was hidden in boilerplate, the borrower failed to understand English, or the lender fraudulently misrepresented the contract terms.[23] Alternatively, the bor-

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[20] *See* JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS § 9-37 (3d ed. 1987) (quoted in Cheshire Mortgage Serv., Inc. v. Montes, 612 A.2d 1130, 1134 n.14 (Conn. 1992)).

[21] *Id. See also* Industralease Automated Sci. Equip. Corp. v. R.M.E. Enters., Inc., 396 N.Y.S.2d 427, 431 (N.Y. App. Div. 1977) ("Procedural unconscionability in general is involved with the contract formation process, and focuses on high pressures exerted on the parties, fine print of the contract, misrepresentation, or unequal bargaining position."); Nelson v. McGoldrick, 896 P.2d 1258, 1262 (Wash. 1995) ("Procedural unconscionability has been described as the lack of a meaningful choice, considering all the circumstances surrounding the transaction including '[t]he manner in which the contract was entered,' whether each party had "a reasonable opportunity to understand the terms of the contract,' and whether 'the important terms [were] hidden in a maze of fine print.'") (quoting Schroeder v. Fageol Motors, Inc., 544 P.2d 20, 23 (Wash. 1975)); *Schroeder*, 544 P.2d at 20 (suggesting that substantive unconscionability, on the other hand, is involved with the content of the terms of the contract per se, such as inflated prices, unfair disclaimers, or termination clauses).

[22] Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 487 (1967).

[23] *See* Harris v. Green Tree Fin. Corp., 183 F.3d 173 (3d Cir. 1999) (determining that Pennsylvania law provides support for certain claims of procedural unconscionability that are based on inconspicuous or unclear contractual language, in particular, if the contracting parties have unequal bargaining power); Monetary Funding Group, Inc. v. Pluchino, 867 A.2d 841 (Conn. App. Ct. 2005) (upholding finding of unconscionability where lender charged arbitrarily high fees and misrepresented the fees to the borrower). *See also* Moscatiello v. Pittsburgh Contractors Equip. Co., 595 A.2d 1190, 1196–97 (Pa. Super. Ct. 1991) (finding disclaimer of warranties clause that appeared in fine print and on reverse side of sales agreement unconscionable when disadvantaged party was not an experienced buyer); Germantown Mfg. Co. v. Rawlinson, 491 A.2d 138, 145–47 (Pa.

rower may point to procedural unfairness involving a lack of voluntariness in situations in which the borrower was under compulsion to obtain the loan, and the lender took advantage of the borrower's circumstances to impose outrageous terms on the borrower.[24] Courts scrutinize the loan transaction to ascertain whether there were any circumstances of compulsion that forced the borrower to enter into the mortgage loan.[25]

Courts generally determine unconscionability under this two-prong analysis, which consists of a substantive and a procedural component. While substantive unconscionability by itself is sometimes sufficient to

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Super. Ct. 1985) (finding confession of judgment clause that appeared in fine print in boilerplate language of standard form contract was unenforceable when party clearly did not understand its significance). *Cf.* Family Fin. Serv., Inc. v. Spencer, 677 A.2d 479 (Conn. App. Ct. 1996) (upholding trial court's determination of unconscionability when the loan payments approximated the borrower's monthly income and the borrower had limited English ability, was uneducated, and could not read well). *But see* Cheshire Mortgage Serv., Inc. v. Montes, 612 A.2d 1130 (Conn. 1992) (upholding the trial court's finding of an absence of procedural unconscionability, which was fatal to the borrowers' claim, despite the borrowers' argument that their mortgage loan was procedurally and substantively unfair and, thus, unconscionable, and that they were unrepresented by counsel and failed to understand English. The trial court found they were competent in the English language and were intelligent persons who understood United States legal and financial systems); Standard Venetian Blind Co. v. Am. Empire Ins. Co., 469 A.2d 563 (Pa. 1983) (stating that failure to read or lack of knowledge of clearly drafted contractual provision does not warrant avoidance or nullification of its provisions).

[24] *See* Besta v. Beneficial Loan Co. of Iowa, 855 F.2d 532 (8th Cir. 1988) (finding both that a loan was unconscionable and that the lender deprived the borrower of fair notice when the recently unemployed borrower called the lender seeking to refinance her loan to cover outstanding obligations, and the lender failed to notify her that she could have received a significantly less expensive loan with a repayment period half as long as the loan actually granted).

[25] *See, e.g.*, Four J. Funding, Inc. v. Land Pres., L.L.C., No. CV0300827345, 2004 WL 3130562, at *3 (Conn. Super. Ct. Dec. 22, 2004) (borrower and guarantor argued the default rate of 2% a month (24% per annum) was unconscionable, but the court found the defendants had a choice not to agree to this default rate at the outset of the loan, or alternatively, to pay the note in a timely manner and thus avoid the default interest rate). *See also* Iamartino v. Avallone, 477 A.2d 124, 126 (Conn. App. Ct. 1984) (finding nondefault interest rate calculated at either 37% or 45% was not procedurally unfair; among other factors, court considered that lender was not the only source of the mortgage loan sought by borrower); Barnes v. Helfenbein, 548 P.2d 1014, 1020 (Okla. 1976) (finding claimant who borrowed money at high nondefault interest rate to avoid foreclosure of commercial property had the alternative of selling the property before foreclosure); Bekins Bar V Ranch v. Huth, 664 P.2d 455, 464 (Utah 1983) (finding loans with 36% and 58% interest rates not unconscionable despite the borrower's compulsion to save ranch, because selling a portion of the ranch would have raised funds to save the rest).

find a contract unconscionable,[26] procedural unconscionability alone will not meet this threshold.[27] Thus, even in the presence of indications of procedural unfairness, a default interest rate should be upheld under the unconscionability standard if the agreed upon default rate of interest is substantively fair and not oppressive.[28] While there is no precise recipe to guide them,[29] when looking for procedural and substantive unconscion-

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[26] *See generally* Steven W. Bender, *Rate Regulation at the Crossroads of Usury and Unconscionability: The Case for Regulating Abusive Commercial and Consumer Interest Rates Under the Unconscionability Standard*, 31 HOUS. L. REV. 721, 747 (1994).

[27] The Court of Appeals of Utah explained this principle: "Utah courts engage in a two-pronged analysis to determine whether a contract is unconscionable: (1) substantive unconscionability and (2) procedural unconscionability. . . . While a determination of substantive unconscionability may by itself lead to our concluding the contract was unconscionable, procedural unconscionability alone 'rarely render[s] a contract unconscionable.'" Cantamar, L.L.C. v. Champagne, 142 P.3d 140, 152 (Utah Ct. App. 2006). *See also* Belcher v. Kier, 558 So. 2d 1039, 1040 (Fla. Dist. Ct. App. 1990) (finding that despite the presence of procedural unconscionability in the formation of land rental agreements, the rent increases in question were not grossly excessive and thus not substantively unconscionable, thereby precluding the court from finding unconscionability in the rental contracts). Procedural unfairness that is sufficiently egregious to invoke contract avoidance, such as fraud and duress, however, may allow invalidation of the contract under these independent doctrines.

[28] The Connecticut Supreme Court recognized the relevance of prevailing charges and rates in assessing the substantive oppression of a mortgage loan transaction. *See* Cheshire Mortgage Serv., Inc. v. Montes, 612 A.2d at 1130, 1138 (Conn. 1992) (finding the terms of the no-income verification loan, including the equivalent of a 33.7% contract nondefault rate, were not so one-sided as to be unconscionable as a matter of law). A California appellate court struck down a contract interest rate of ten times the market interest rate by reference to price unconscionability cases for sales of goods under the UCC. *See* Carboni v. Arrospide, 2 Cal. Rptr. 2d 845 (Cal. Ct. App. 1991). These cases typically relieve purchasers from the contract price under the unconscionability doctrine only when the contract price is more than two times the retail value of the goods. *See generally* Bender, *supra* note 26, at 756.

[29] See *Pierce v. Emigrant Mortgage Co.*, 463 F. Supp. 2d 221, 225–26 (D. Conn. 2006) for a detailed analysis of the factors considered when evaluating procedural and substantive unconscionability in the context of default interest rates. The procedural factors include representation by counsel in the formation of the contract and potential conflicts of interest influencing that counsel, and the substantive factors include interest rate terms, loan acceleration, and late fees. Suppose, for example, the contract (nondefault) interest rate is an adjustable rate, and the loan has a fixed default rate and a lengthy loan term. The rate spread between the fixed default rate and the contract rate may decrease over the life of the loan due to inflationary pressures in the economy that drive the adjustable contract rate up thus reducing the lender's compensation for risk and damages in the event of default. Indeed, if inflationary pressures during the next three decades (for a thirty year residential loan) recapture the high interest rates of the late 1970s and early 1980s, despite the prevailing contract rates today in the single digits, an 18% default rate, for example, would approximate the interest rates charged twenty-five

ability, courts tend to apply a "sliding scale" analysis, under which a compelling finding of one prong of unconscionability might support a determination of unconscionability in the face of a weaker prong.[30]

III. ENFORCEABILITY UNDER THE REASONABLENESS STANDARD

When scrutinizing contractual late charges, courts tend to apply the liquidated damages standard of reasonableness rather than a relaxed (from the lender's viewpoint) standard of unconscionability.[31] But appellate courts in some jurisdictions (for example, New Jersey and Indiana) have begun to apply this reasonableness standard to determine whether default interest provisions in real estate mortgages are enforceable.[32] Under the reasonableness standard, a court, taking into account the totality of surrounding circumstances, will determine whether actual damages are difficult to establish and also whether the default interest rate is reasonably related to the anticipated or actual damages the lender suffered as a result of the default.[33]

Applying this standard, in *MetLife Capital Financial Corp. v. Washington Associates*[34] the New Jersey Supreme Court observed that default interest rates, like late fees, are presumed to be reasonable.[35] However, an unreasonable increase in the contract interest rate is unenforceable if the

years ago to the most creditworthy of borrowers with no hint of inability to repay. Courts should recognize the utility of specifying a fixed default rate in the loan documents to cover the full life of the loan.

30 *See* Bender, *supra* note 26, at 747. Consistent with the need for a finding of substantive unfairness as required by most courts, presumably those courts applying a sliding scale might be willing to find unconscionability in situations in which there is great procedural unfairness but only slight substantive unfairness.

31 *See* MADISON ET AL., *supra* note 5, § 5:106.

32 *See* Art Country Squire, L.L.C. v. Inland Mortgage Corp., 745 N.E.2d 885, 893 (Ind. Ct. App. 2001) (adopting a reasonableness test citing *MetLife*, stating "[w]e agree with the court's reasoning, and we therefore decline Inland's apparent invitation to abandon the reasonableness test."); MetLife Capital Fin. Corp. v. Wash. Assocs., L.P., 732 A.2d 493 (N.J. 1999).

33 Sometimes the court confuses and conflates the reasonableness standards under the liquidated damages analysis and the unconscionability standards in cases concerning default rates. *See, e.g.*, *Cantamar, L.L.C. v. Champagne*, 142 P.3d 140, 151 (Utah Ct. App. 2006) (considering whether default rate constitutes an unenforceable penalty by determining whether the rate is unconscionable).

34 732 A.2d at 502.

35 *See* Mony Life Ins. Co. v. Paramus Parkway Bldg., Ltd., 834 A.2d 475 (N.J. Super. Ct. App. Div. 2003) ("It is settled that a stipulated damages clause, such as that present here providing for contractual default interest and a prepayment fee, negotiated between sophisticated commercial entities, is presumptively reasonable. . . . Thus, the party challenging the clause bears the burden of proving its unreasonableness.").

size of the enhanced rate on default suggests punitive intent on the part of the lender. The reasonableness standard is founded on a liquidated damages versus penalty analysis that looks to the impact of default and not necessarily to the bargaining power or sophistication of the parties when the contract was made. Therefore, the bar for meeting the reasonableness standard should be the same regardless of whether the mortgage loan is secured by residential or commercial property.

In situations in which courts have applied the reasonableness standard to commercial and residential mortgage loans, a review of case decisions indicates that courts nevertheless tend to uphold default interest rates, particularly when they are within the bounds of industry custom. Courts even have upheld default interest increases of 12 percent or more over the regular contract rate and default rates of 18 percent or more,[36] but these cases turn on the prevailing custom in the marketplace and other circumstances unique to each loan.

In explaining the liquidated damages analysis in *MetLife*, the New Jersey Supreme Court articulated the reason actual losses resulting from a loan default are difficult to ascertain:

> The lender cannot predict the nature or duration of a possible default given many possible causes of borrower delinquencies. Nor is it possible when the loan is made to know what market conditions might be ten or fifteen years hence and, thus, what might be recovered from a sale of the collateral. For example, a lender cannot know what its own borrowing costs will be if the borrower defaults in paying a loan in the future, nor accurately predict what economic return it will lose when the borrower fails to repay the loan on time or how much in costs it will incur if the property is foreclosed or the borrower files for bankruptcy.[37]

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[36] *See* Citibank, N.A. v. Nyland, Ltd., 878 F.2d 620, 625 (2d Cir. 1989) (sustaining 17.5% default rate); *In re* Liberty Warehouse Assocs. Ltd. P'ship, 220 B.R. 546, 552 (Bankr. S.D.N.Y. 1998) (upholding 14% to 22.8% default rate); *In re* Dixon, 228 B.R. 166, 170 (Bankr. W.D. Va. 1998) (allowing default rate that doubled the contract rate of 18%); River Bank Am. v. Tally-Ho Assocs., Civ. A. No. 90L-JN-21, 1991 WL 35719, at *6 (Del. Super. Ct. Feb. 22, 1991) (upholding 10% to 24%); Chem. Bank v. Am. Nat'l Bank & Trust Co. of Chi., 535 N.E.2d 940, 947 (Ill. App. Ct. 1989) (sustaining greater of 4% over prime or 20%).

[37] *MetLife*, 732 A.2d at 503.

As the court in *MetLife* held, the reasonableness test can be applied either as of the time when the contract was made or when it was breached.[38]

In addition to the factors mentioned above, the lender's internal costs of administering the defaulted loan are difficult to ascertain. As the New Jersey Supreme Court pointed out in *MetLife*, these costs might include "sums required in the context of collection activity, such as travel costs, expert fees and the costs of its loan officers' involvement in collection activities."[39] Moreover, although the lender conceivably could keep track of the time its employees spend addressing the defaulted loan, it would be challenging for a court to determine an appropriate hourly rate of compensation for the lender.[40] Other costs relating to default that are difficult to quantify include the impact on the lender's financial statements caused by the lack of anticipated investment capital from repayment of the defaulted loan.

Moreover, it would be difficult, if not impossible, for a lender to estimate the cost of lost investment opportunities caused by the borrower's default. For example, in the event of a payment default, a lender may not be able to raise the threshold amount it needs to achieve a higher rate of reinvestment through investing in overnight funds and other investments that depend on the amount of capital the investor can pool in a short period of time.

As the court pointed out in *MetLife*, a legitimate factor in assessing the reasonableness of default interest is the heightened risk of nonpay-

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[38] *See id.* ("adopt[ing] the 'modern trend' that the reasonableness test is applied either at the time the contract is made or when it is breached."). This view suggests that if a court finds the liquidated damages clause to be reasonable at either the time of contract or of breach then it will be enforceable. *See also* Thanksgiving Tower Partners v. Anros Thanksgiving Partners, 64 F.3d 227, 232 (5th Cir. 1995); Yockey v. Horn, 880 F.2d 945, 952–53 (7th Cir. 1989) (upholding liquidated damages clause when reasonable damages estimate could be made at time of breach or at time of contract formation). However, a number of jurisdictions, including Massachusetts, apply the reasonableness standard only at the time the contract is formed. *See* Kelly v. Marx, 705 N.E.2d 1114, 1116 (Mass. 1999) ("We agree . . . that a judge, in determining the enforceability of a liquidated damages clause, should examine only the circumstances at contract formation."). A few other jurisdictions, including California and Louisiana, have resolved the issue by statute. *See* Weber, Lipshie & Co. v. Christian, 60 Cal. Rptr. 2d 677, 681 (Cal. Ct. App. 1997) (quoting CAL. CIV. CODE § 1671(b)). By contrast, the unconscionability analysis should be applied at the time the contract was made. See U.C.C. § 2-302(1) (amended 2003), 1 U.L.A. 404 (2004) ("If the court as a matter of law finds the contract or any term of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract. . . . ").

[39] *Metlife*, 732 A.2d at 503.

[40] *See id.*

ment that the lender faces in the event of a default.[41] Suppose for example, after defaulting on a loan and having the indebtedness to a lender accelerated, the borrower were to approach another bank or lending institution asking the new bank for a new loan of the indebtedness amount to redeem and refinance the defaulted loan with the original lender. Assuming that the new lender would be willing to lend money to borrowers who had already proven themselves to lack creditworthiness, what interest rate would the new lender charge for refinancing? If the new lender were willing to make the loan, the lender likely would charge a rate substantially higher than the original loan's contract rate to compensate for the exceedingly high risk of default. This additional risk premium justifies the step-up from the regular contract rate to the default interest rate.

Noted real estate practitioner Harris Ominsky pointed out a related "car wreck factor" justifying increased compensation for the lender in the event that the borrower cures the default and restores the loan.[42] He likens the mortgage loan, once subject to a default, as akin to a once-wrecked automobile. Although the car is repaired, it is "forever blemished in the marketplace."[43] Similarly, even if a borrower cures the default, "the loan may be worth less on resale [in the secondary or securitization markets] because the borrower has demonstrated its unreliability."[44]

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41 *See id.*

42 OMINSKY, *supra* note 7, at 68. Even where the loan has been accelerated, it is possible that the borrower may convince the lender to allow reinstatement and cure of the loan, or the borrower may be entitled to cure by contract provisions, the statutory rights to reinstatement in some jurisdictions, or the cure of the loan by a Chapter 11 reorganization plan. As discussed *supra* at note 2, it is unclear whether such reinstatement laws would allow a surviving default rate. For bankruptcy purposes, the reorganization plan potentially can nullify the lender's right to receive continued default interest. *See, e.g.*, *In re* Entz-White Lumber & Supply, Inc., 850 F.2d 1338 (9th Cir. 1988), *called into question by* 11 U.S.C. § 1123(d) (2000) (ruling that after curing all defaults under bankruptcy plan, debtor was entitled to nullify all consequences of default, including default interest rate). *But see* Hassen Imports P'ship v. KWP Fin. VI 256 B.R. 916, 924 n.13 (B.A.P. 9th Cir. 2000) (questioning the continuing validity of *Entz-White* in light of 1994 amendments to the Bankruptcy Code, 11 U.S.C. § 1123(d) (2000), that provide the amount needed to cure a default "shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law"); *In re* Liberty Warehouse Assocs. Ltd. P'ship, 220 B.R. 546 (Bankr. S.D.N.Y. 1998) (finding where loan matured prepetition, creditor entitled to interest at default rate, rejecting Chapter 11 plan proposal to pay creditor at nondefault rate).

43 OMINSKY, *supra* note 7, at 68.

44 *Id.*

IV. DEFAULT RATES IN BANKRUPTCY

Most reported cases scrutinizing default interest clauses are decided in the context of federal bankruptcy proceedings. In the case of post-petition default interest, some bankruptcy courts apply a reasonableness standard on the assumption that they are mandated to do so under section 506(b) of the Bankruptcy Code.[45] This section allows the lender "interest on [its mortgage loan balance] claim, and any reasonable fees, costs, or charges provided for under the agreement."[46] Some courts have recognized that under the plain language of this provision the interest rate arguably need not be reasonable. Rather, reasonableness is required only of "fees, costs, or charges" such as late fees or prepayment charges.[47] Nevertheless, most bankruptcy courts tend to invoke equitable principles and limitations in subjecting the default interest provision to stricter scrutiny than under an unconscionability or exorbitance standard.[48]

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45 *See, e.g.*, *In re* AE Hotel Venture, 321 B.R. 209 (Bankr. N.D. Ill. 2005) (treating default interest as a late fee rather than as interest and thus subject to the statutory reasonableness requirement).

46 11 U.S.C. § 506(b) (2000).

47 K & J Prop., Inc. v. PWP Golden Eagle Tree, LLC, 338 B.R. 450 (Bankr. D. Colo. 2005).

48 *See In re* Southland Corp., 160 F.3d 1054, 1060 (Tex. 1998) (allowing a default rate 2% higher than the contract rate to apply because default interest rates are generally allowed unless the "higher rate would produce an inequitable . . . result") (quoting *In re* Laymon, 958 F.2d 72, 75 (5th Cir. 1992)). *See also In re* Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994) ("What emerges . . . is a presumption in favor of the [default] contract rate subject to rebuttal based upon equitable considerations."). *See generally* Craig H. Averch, Michael J. Collins & Stephen A. Youngman, *The Right of Oversecured Creditors to Default Rates of Interest from a Debtor in Bankruptcy*, 47 BUS. LAW. 961 (1992) (critizing bankruptcy courts applying equitable discretion to constrain enforcement of contractually agreed-upon default rates).

V. ENFORCEABILITY UNDER USURY LAWS

Some courts have held that usury laws constrain default interest[49] based on the rationale that a default interest rate that supersedes the contract rate is nevertheless an interest rate for usury purposes because it constitutes compensation for the use of borrowed funds.[50] Default interest is a heightened interest rate designed to compensate the lender for the increased risk of lending to an already defaulting borrower and, unlike late fees, is not intended to penalize the borrower for being in default. Therefore, usury laws arguably should apply just as they would to other types of interest rates, such as contingent rates or participating mortgages with so-called "equity-kickers."[51] But many courts have held the contrary,

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[49] Like a savings clause that attempts to protect a lender against a usury claim, lenders frequently add disclaimer language in the note, mortgage, or both to govern default rates and late fees. A typical disclaimer clause might read as follows: "If the law governing loan charges is finally interpreted so that the interest or other loan charges collected in connection with the loan exceed the permitted limits, then such excess shall be credited to reduce the principal balance of the loan, or any excess sums already collected shall be refunded to the Borrower." Such disclaimers are of questionable value. *See* Jersey Palm-Gross, Inc. v. Paper, 658 So. 2d 531, 535 (Fla. 1995) (upholding a finding of usury notwithstanding a savings clause and concluding "a usury savings clause cannot, by itself, absolutely insulate a lender from a finding of usury."). *See also* Swindell v. Fed. Nat'l Mortgage Ass'n, 409 S.E.2d 892, 896 (N.C. 1991) (holding "the 'usury savings clause' . . . cannot shield a lender from liability for charging usurious rates," the court reasoned as follows: "The [usury] statute relieves the borrower of the necessity for expertise and vigilance regarding the legality of rates he must pay. That onus is placed instead on the lender, whose business it is to lend money for profit and who is thus in a better position than the borrower to know the law. A 'usury savings clause,' if valid, would shift the onus back onto the borrower, contravening statutory policy and depriving the borrower of the benefit of the statute's protection and penalties. . . . A lender cannot charge usurious rates with impunity by making that rate conditional upon its legality and relying upon the illegal rate's automatic rescission when discovered and challenged by the borrower."). Other jurisdictions are divided over whether the existence of a usury savings clause will insulate the lender from usury sanctions in such situations. Texas courts repeatedly have acknowledged the validity of usury savings clauses and enforced such clauses to defeat a violation of the usury laws. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 786 (Tex. 1977); Woodcrest Assocs., Ltd. v. Commonwealth Mortgage Corp., 775 S.W.2d 434, 437 (Tex. App. 1989). *But see* C & L Invs. v. Fiesta Group, Inc., 248 S.W.3d 234, 244 (Tex. App. 2007) (observing this outcome is limited to appropriate circumstances and stating the mere presence of a savings clause will not rescue a transaction "necessarily usurious by its explicit terms.").

[50] *See, e.g.*, Wagnon v. Slawson Exploration Co., 874 P.2d 659, 660 (Kan. 1994) ("When a note provides for a higher rate of interest after default or maturity, interest at that rate is recoverable if it is not in contravention of the usury law or otherwise illegal.").

[51] *See* Brown v. Cardoza, 153 P.2d 767, 769 (Cal. Ct. App. 1944) ("The law is well settled in most jurisdictions, including California, that where there is a loan of money to

reasoning that default interest is invoked depending upon a contingency within the borrower's control, namely, the failure to make a timely payment.[52] In any event, the issue is moot for most banks and other lenders because statutory exemptions exist under federal and state law that apply to many types of mortgage loans.[53]

VI. UNCONSCIONABILITY STANDARD SHOULD GOVERN

Late charges in mortgage loan transactions speak principally to the defaulting borrower's past conduct, whereas default interest mainly addresses the lender's risk of future loss based on the borrower's actual payment performance. Accordingly, late charges are in the nature of damages for the borrower's breach of the contractual promise to make timely debt-service payments. Therefore, in scrutinizing the enforceability of late payment charges under state law, courts tend to apply the liquidated damages standard of reasonableness. By contrast, in testing the enforce-ability of default interest provisions, courts more often have applied the more lax (from the lender's perspective) unconscionability standard.[54]

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be compensated for by a share in earnings, income or profits, in lieu of or in addition to interest, in determining whether the transaction is usurious the share of earnings, income or profits must be considered as interest.").

[52] *See, e.g.*, Hayes v. First Nat'l Bank of Memphis, 507 S.W.2d 701 (Ark. 1974) (holding that such charges were free from usury because the purchaser had it in his power to avoid the penalty by paying the debt); First Am. Title Ins. & Trust Co. v. Cook, 90 Cal. Rptr. 645 (Cal. Ct. App. 1970); Stuchin v. Kasirer, 568 A.2d 907 (N.J. Super. Ct. App. Div. 1990); Heelan v. Sec. Nat'l Bank, 343 N.Y.S.2d 417 (Dist. Ct. Suffolk County 1973); *see generally* Bruce J. Bergman, *Interest Rate Upon Default*, 218 N.Y.L.J. 5 (1997). *But see* Begelfer v. Najarian, 409 N.E.2d 167, 172 (Mass. 1980) (rejecting the *Hayes* rationale because "[t]his argument assumes that persons who do not make timely payments are financially able to do so, but voluntarily choose not to pay.").

[53] Federal law preempts the application of state usury limits to many residential loans. *See* Bender, *supra* note 26, at 733. There is also a myriad of state law exceptions to those usury laws that survive. *See* CAL. CORP. CODE § 25118 (West 2004) (exemption from the state usury law where parties have a "preexisting personal or business relationship," or if the parties "could reasonably be assumed to have the capacity to protect their own interests in connection with the transaction"); 815 ILL. COMP. STAT. 205/4 (2007) (exemption from the state usury law for any loan made to a corporation); MASS. GEN. LAWS ch. 271, § 49 (2007) (usury law shall not apply when a party notifies the attorney general of its intent to engage in the transaction); MO. REV. STAT. § 408.035 (2007) (offering numerous exemptions from the usury laws including exemption of all loans to corporations, general partnerships, limited partnerships, or limited liability companies).

[54] *See* STEVEN W. BENDER, CELESTE M. HAMMOND, MICHAEL T. MADISON, & ROBERT M. ZINMAN, MODERN REAL ESTATE FINANCE AND LAND TRANSFER: A

Courts that apply a liquidated damages or reasonableness standard to default rates incorrectly view a default interest rate as a provision for determining damages for breach of contract.[55] Rather, the default rate is a contractual interest rate that supersedes the regular contract rate when the investment risk for the lender is increased because of default, and should be respected as such under freedom of contract principles. Default interest is a contractual rate that adjusts on default in the same way a variable interest rate in a loan contract changes as the risk of inflation fluctuates over time.[56] Another example is a participating mortgage loan in which the interest charged to the borrower is a contingent rate that can change depending upon the gross or net income received by the borrower from the mortgaged property.[57]

TRANSACTIONAL APPROACH 243–45 (4th ed. 2008). *See, e.g.*, Pierce v. Emigrant Mortgage Co., 463 F. Supp. 2d 221, 226 (D. Conn. 2006) (applying Connecticut law).

Lenders should be aware of the potential remedies awarded for rates held to be unconscionable. The few cases actually finding the challenged rate to be unconscionable generally have reduced the excessive rate to a fair one without further penalty. *See, e.g.*, Carboni v. Arrospide, 2 Cal. Rptr. 2d 845, 847–51 (Cal. Ct. App. 1991), (affirming trial court's reduction of 200% rate to 24%). *See also In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 875 (E.D. Pa. 1966) (instructing bankruptcy judge on remand to reduce to a reasonable rate any interest it finds unconscionable). *But see In re* White, 88 B.R. 498, 511 (Bankr. D. Mass. 1988) (holding 58% default rate unconscionable; the court said it lacked authority to reform the note to a reasonable default rate, but the lender apparently could recover at the 16.5% nondefault contract rate).

[55] Applying the liquidated damages standard to default interest, thus treating late fees and default interest alike, is not entirely free of reason. Late fees compensate for the otherwise unreimbursed internal costs of administering the defaulted loan, and thus are suited for the liquidated damages analysis. Default interest, by contrast, is meant to compensate for the additional risks posed by the borrower who has proven to be uncreditworthy. But some portion of the default rate is meant to encompass internal costs of administering the defaulted loan and other damages that could be said to flow from the borrower's breach. This component of default interest arguably calls for the reasonableness standard. Ironically, the tendency of courts to view the collection of late fees and default interest at the same time as untenable might compel lenders to separate their collection and thus enhance the possibility that the default rate might invoke the reasonableness standard. On balance, the compensation function of default interest for risk management outweighs the internal cost reimbursement function and, therefore, default interest is best scrutinized under the unconscionability standard and not the more strict (from the lender's perspective) liquidated damages or reasonableness analysis.

[56] *See* Bender, *supra* note 26, at 774–75 (articulating the elements of a fair contract interest rate to encompass the risk of inflation, as well as the lender's cost of obtaining the money lent, its cost in making and administering the loan, the risk of default, and the need for a fair profit over these risks and costs).

[57] *See* MADISON ET AL., *supra* note 5, at § 5:17.

Default interest provisions also can be described as a variable-pricing provision, a term of the contract that provides for an interest-rate increase if the lender's risk of future loss is increased by borrower default. Courts recognize that default interest represents a variable interest rate that reflects the heightened risk of repayment triggered by the borrower's default.[58] Such a variable-pricing mechanism makes economic sense for lenders. Suppose, for example, that a bank that makes residential mortgage loans to one hundred customers per year was compelled to foreclose on three or four properties per year because of borrower default. A reasonable business strategy for the bank is to segregate the defaulting borrowers from the credit worthy borrowers and charge the former a large enough rate of default interest to make itself whole again. Then, the bank still is able to offer competitive rates on loan products in a fiercely competitive marketplace. This way, the class of borrowers responsible for the heightened risk shoulders the financial burden posed by the risk of default, rather than having the lender's innocent customers bear the risk.

This approach is a mainstay of the credit card industry. Banks that make credit card loans at low introductory rates automatically will relegate a defaulting borrower to a high-risk category where interest charges can double or triple. For example, as of late July 2006, Bank of America Rewards American Express Card was offering a promotional rate of 0 percent on credit card access checks and balance transfers from July 2006 to June 2007 with the understanding that if any payment was not received by the due date the rate would automatically increase to 24.99 percent.[59] Similarly, alternative pricing based on risk levels has been used commonly in the real estate investment community. For example, in marketing securities on Wall Street, Real Estate Mortgage Investment Conduits and other mortgage conduits offer collateralized mortgage obligations and commercial mortgage-backed securities to separate classes or "tranches" of investors based on varying price-risk ratios.[60]

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58 *See, e.g.*, Citibank, N.A. v. Nyland Ltd., 878 F.2d 620 (2d Cir. 1989). The court concluded that the default rate in question was "simply part of . . . [the] bargain" included to offset the "increased risk of non-collection." *Id.* at 625. The court further opined that when creditors are not allowed to impose such variable rates based on performance or default it would be worse for debtors overall who would likely see increased rates over the entire life of the loan in order to "reallocate the risk" of default. *Id.*

59 Arguably, credit card loans hold fewer options for the distressed borrower than realty loans. Credit card borrowers in default likely will suffer the default rate on the uncollateralized loan until the balance is paid down over time. By contrast, the realty borrower at least has the option, should it perceive unfairness in the default rate, of selling the collateral and redeeming the loan.

60 For example, mortgages are purchased from banks and sold to a trust that issues

Compelling public policy reasons exist as to why courts should not apply the stricter reasonableness standard to default rates:

(1) A restrictive judicial approach that impedes the enforceability of default interest provisions could have a devastating impact on the secondary mortgage market for commercial and residential loans and the securitization of these loans by mortgage conduits that depends on standardization of loan terms and uniformity in legal treatment of such terms.

(2) Mortgages held on properties in a reasonableness standard state would be less desirable investments for institutional investors (who serve as a source of real estate financing) than investments in states with the unconscionability standard. This would encourage movement of debt capital outside the state or higher contract (nondefault) interest rates for borrowers.[61]

(3) Restricting enforceability of default interest provisions would disrupt customary and traditional mortgage lending practices.

(4) Restricting enforceability of default interest provisions would force lenders to add the costs compensated by such provisions to the initial contract rate of interest, thus penalizing meritorious borrowers who have proven creditworthy over the life of the mortgage loan by increasing their borrowing costs.

VII. PLANNING SUGGESTIONS FOR LENDERS

The following practice tips should aid lenders in any challenge to the default interest rate, particularly those leveled under the common law doctrine of unconscionability:

(1) Ride with the herd. Lenders should set their default rates with an eye toward those of the market.[62] Lenders already tend to do this for the contract rate given the intense competition for rates in the marketplace. Apart from consistency with rates of competitors for similar loans, lenders should be prepared to justify any rate in terms of the actual or threatened

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securities called collateralized mortgage obligations (CMOs) with different priorities as to mortgage payment flows and claims against the underlying assets that are being mortgaged. Typically, debt-service payments are first used to service the senior class, or tranche, and to retire these Class A securities. Purchasers of these senior debt securities will pay more for their securities as compared to purchasers of the higher-risk junior debt obligations. *See* MADISON ET AL., *supra* note 5, ch. 4.

[61] *See* OMINSKY, *supra* note 7, at 83 (observing that a state that scrutinizes default interest and late charges too vigorously might cause higher contract interest rates for in-state borrowers or cause lenders to avoid the state).

[62] *See* Metlife Capital Fin. Corp. v. Wash. Ave. Assocs., 732 A.2d 493, 501 (N.J. 1999) (looking to evidence of industry custom in enforcing default rate under reasonableness standard).

risk posed to the lender by default, including the potential costs the lender would incur on default by a particular borrower and upon default of borrowers in the same or similar loan programs.

(2) Do not be a greedy hog. Although courts may tolerate some mild forms of overreaching, they tend to eat hogs. Most cases striking down default interest under an unconscionability or reasonableness standard, or even by a balancing of the equities in bankruptcy, do so when the default rate is more than double the base contract rate.[63] This is related to the tendency of courts, in the context of sales of excessively priced goods, to be critical of a price more than double the retail price.[64] If the default rate is double or more than double the contract rate, lenders should be prepared to justify that rate. Similarly, some courts look to the spread between the default rate and the contract rate.[65] For example, a contract rate of 24 percent and a default rate of 40 percent might be less than double the nondefault rate but still raises eyebrows because of the 16 percent differential.[66]

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[63] *See, e.g.*, *In re* Hollstrom, D.C., 133 B.R. 535, 539–40 (Bankr. D. Colo. 1991) (deeming 36% default rate a penalty when contract rate was 12% and there was no evidence to justify default rate); *In re* White, 88 B.R. 498, 511 (Bankr. D. Mass. 1988) (deeming 48% default rate a penalty when nondefault rate was 16.5% and default rate was grossly disproportionate to damages incurred by breach). In the case of a variable rate that may fluctuate over the life of the loan, the court inclined to consider a disparity ratio should anticipate such movement of the contract rate over the loan term in judging the fairness of a default rate that might apply at any time during the life of the loan.

[64] *See* Bender, *supra* note 26, at 756. Still, courts applying the unconscionability standard disdain any fixed mathematical ratio of substantive fairness. *See id.*

[65] Courts that simply look at the ratio of the default rate to the contract rate misunderstand the unconscionability analysis. The cases that look to the difference between retail price and the actual sale price of goods, or at the seller's net profit in relation to net profits of other sellers, are inapposite in a mortgage loan context. In the context of the sale of goods, presumably the court can determine the seller's unique costs that are readily determinable at the time of the sale. Mortgage lending is different. The default rate represents the lender's estimation of its risks on default looking forward as much as thirty years, and thus deserves appropriate leeway in the exorbitance analysis. Rather than compare the nondefault rate to the default rate, courts more properly might compare the charged default rate to a fair default rate in light of the lender's particular risks anticipated in the future. If that default rate is more than double the fair rate, then it might be exorbitant. Still, some courts compare the contract nondefault rate to the default rate, so the advice given above is well taken.

[66] *See, e.g.*, *In re* Liberty Warehouse Assocs. Ltd. P'ship, 220 B.R. 546, 552 (Bankr. S.D.N.Y. 1998) (observing that the spread between the nondefault and default rates of interest of 8.8% was smaller than the differential present in most cases in which courts found the default rate to constitute a penalty, citing spreads of 9% to 10%, 14.5%, 18%, 24%, and 35%).

(3) Lenders who charge default interest should take special measures to assure the procedural fairness of their loans, especially when the default rate significantly exceeds[67] the customary default rate, or when the contract rate exceeds the prevailing nondefault contract rate.[68] Sometimes the lender requires the borrower to sign a separate default interest rate rider attached to the note, the mortgage, or both. In addition, the loan commitment letter may require the borrower to acknowledge that the borrower has consulted with an attorney to make certain that the borrower understands the legal consequences of such default provisions. Courts are more likely to find borrowers represented by counsel to be sophisticated. Represented or not, lenders might have their borrowers acknowledge in writing by means of a default rate rider, or in the note or mortgage itself, that the rate charged is justified in relation to the loan risks and costs, and that the borrower understands the rate charged. The same efforts to avoid the image of an inexperienced borrower who is relying solely on the lender for advice and protection can aid lenders in lender liability litigation when the loan relationship is alleged to be a fiduciary one. In general, lenders should avoid misrepresentation or manipulation to mask the contract or default rate they plan to charge.

(4) Unlink late fees from default interest. In both drafting and application of loan provisions, lenders should ensure that any late fee operates separately from the default rate. For example, the loan documents should not authorize late fees following acceleration. The default rate might be best limited to the time period after acceleration, thus preventing late fees and default interest from overlapping.[69]

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[67] This suggestion is based on the tendency of courts, when striking down price terms for unfairness under the unconscionability standard, to do so where the price is at least double the fair value of the goods. Arguably, then, the default rate ought to survive unless it is more than twice what a fair interest rate on default would be.

[68] As with the default rate, the nondefault contract rate is subject to scrutiny under the unconscionability standard. *See generally* Bender, *supra* note 26. Because the nondefault rate governs in the absence of a breach, there should be no occasion whatsoever to consider application of the reasonableness standard for liquidated damages to the nondefault contract rate.

[69] Of course, as discussed *supra* at note 55, unlinking default interest and late fees actually could increase the likelihood of a reasonableness standard being applied to the enforceability of the default interest. An alternate approach would be for the lender to draft the loan documents to allow the concurrent recovery of default interest and late charges but to articulate in the loan documents the justification for these respective charges and ensure that, while all possible costs and risks are addressed, there is no overlap in their articulation.

Triggering the default rate upon acceleration, rather than after default, will require some post-default attention to navigate a Ninth Circuit decision that ignored the language

(5) The commercial lender confronted with an unconscionability challenge to its rate should set the tone for the dispute by citing to court decisions that have counseled judicial restraint in interfering with commercial interest rates.[70] The lender also might try to argue in cases of first impression that judicial review for conscionability is inconsistent with the legislature's exclusion of commercial loans from the state's usury limits.[71] Finally, the lender could point to decisions according wide latitude when determining whether the foreclosure price is so low that it shocks the court's conscience—in essence an unconscionability challenge.[72]

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of the mortgage note and required that the lender provide the debtor notice of acceleration before it could begin collecting default interest. *See In re* Crystal Props., Ltd., L.P., 268 F.3d 743 (9th Cir. 2001) (although note provided for acceleration and accrual of default rate without notice or demand, court held the lender needed to take affirmative action to put the debtor on notice that it accelerated loan, which in this case was not until the lender recorded a notice of default).

[70] *See, e.g., In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 871 (E.D. Pa. 1966) ("There are important considerations of policy in favor of promoting the availability of funds for businesses in distress, even at unusually high rates of interest"); Bekins Bar V Ranch v. Huth, 664 P.2d 455, 464 (Utah 1983) ("To find unconscionability on these facts would discourage other lenders from advancing funds to businesses that find themselves in financial difficulty because of the possibility that a court would disallow the cost of high risk capital"). *See also* Shriver v. Druid Realty Co. of Balt. City, 131 A. 815, 819 (Md. 1926) (holding that to relieve corporation from alleged excessive rate would chill credit for "hazardous or venturous enterprises."). Because commercial loans tend to involve sophisticated borrowers, or borrowers represented by counsel, there is a greater likelihood that courts will find an absence of unfair surprise in such loans and thus an absence of unconscionability, leading the courts to defer more often to freedom of contract in the commercial loan setting. *See, e.g.*, LaSalle Nat'l Bank v. Freshfield Meadows, L.L.C., No. CV 9903648315, 2004 Conn. Super. LEXIS 3648, at *3 (Conn. Super. Ct. Dec. 9, 2004) (enforcing default rate of 24% when the contract rate was 11.95%, saying there was "no reason why, in a commercial transaction, the [borrower] should not be bound by the agreement that it made."); *In re* Dixon, 228 B.R. 166, 177 (Bankr. W.D. Va. 1998) (upholding a 36% default rate in a "lawful business transaction between sophisticated parties").

[71] *See* Bender, *supra* note 26, at 747.

[72] RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 8.3 cmt. b (1997) (observing that while "gross inadequacy" cannot be defined precisely, generally the court is not warranted in setting aside a foreclosure sale, without any procedural defects in the sale process, that yields more than 20% of fair market value). *See also* MADISON ET AL, *supra* note 5, § 12:40 n.8 (referencing cited cases). This is akin to the unconscionability analysis with which some courts might find unconscionability based on substantive oppression in the absence of procedural unfairness, but presumably would demand a greater showing of inequity—hence at least a five to one disparity in price as the *Restatement* suggests. *See id.* (noting that some courts are unwilling to overturn sales for gross inadequacy of price alone, no matter how gross, without some procedural irregularity in the sale—in essence concluding that substantive unconscionability alone is not enough without some

(6) Pick one default rate formula and stick with it. Two-quarterback systems may work in some college football programs, but they are risky in commercial loans. Sometimes lenders structuring the default rate borrow a page from the typical late fee formula that uses the greater (or lesser) of a fixed dollar amount or a percentage of the late payment. In one reported case, the mortgagee's default rate was the greater of the contract rate plus 3 percent or the prime rate (as defined in the mortgage note) plus 4 percent. Although the court rejected the argument that a default formula tied to the greater of two formulas was an unreasonable penalty per se, the lender invited trouble from a court with less deference to the contract.[73]

VIII. CONCLUSION: LESSONS FROM THE CURRENT MORTGAGE MELTDOWN

In 2008, a crush of media attention spotlighted the deluge of mortgages in default as well as the depression in the housing market in many areas with stagnant sales and falling prices. Many lenders of troubled loans were agreeing to "short sales"—a voluntary reduction of the mortgage loan balance to enable their borrower to sell the property free and clear of the mortgage to avoid a foreclosure and resale in what then might be an even worse market. The epidemic of short sales in lieu of foreclosures suggested that, in many markets, the collateral value, with the transactional costs of resale, had fallen below the loan balance. In such a distressed market, lenders no doubt will incur losses whether absorbing short sales or dealing with recalcitrant borrowers in foreclosure. Here, default rates may hold little significance, as either judgment proof borrowers or those protected by state deficiency laws may escape any impact of default rates when the lender forecloses in a wounded market with depressed values. Lenders must recoup those losses in better markets when the stars align and the lender finds itself facing the borrower's default with the collateral actually worth more than the loan balance and

procedural unfairness).

[73] *See* Norwest Bank Minnesota v. Blair Road Assocs., L.P., 252 F. Supp. 2d 86 (D.N.J. 2003) (applying the New Jersey standard of reasonableness to default interest but concluding that the alternative formula was simply an effort to address the vagaries of market conditions the lender faced). In the analogous context of real estate purchase agreements, some courts have applied the liquidated damages versus penalty standard to strike down default clauses giving the seller the option on the buyer's default to retain a specified amount of earnest money or to elect to recover its actual damages. *See, e.g.*, Lefemine v. Baron, 573 So. 2d 326 (Fla. 1991).

the transaction costs of foreclosure. Lenders also continuously recoup a portion of default losses from performing loans that weather real estate downturns. But do these meritorious borrowers deserve to bear the full brunt of bad loans and bad borrowers?

The current crisis reminds lenders (who received the same telegram in the late '80s–early '90s savings and loan crisis) that mortgage collateral can be a risky business, but the reminder is lost in the firestorm of finger pointing. Until the recent rout in the asset-based mortgage markets lenders were able to sell a loan, earn up-front transaction fees, and pass the risk of default to third parties in the secondary mortgage markets. As a result, underwriting standards were compromised just like they were prior to the real estate shakeout starting in the late 1980s when office building loans were being made in some areas despite vacancy rates of 20 percent or more. There will be pressure in the markets to recoup and price this risk into future loans. At the same time, borrowers are more attuned than ever to the interest rates they are paying, meaning something has to give. Courts need to recognize the utility of lenders offering lower interest rates based on the condition, borrowed from the car insurance industry, that they remain accident-free. Should a default occur, the damaged loan justifies a higher rate commensurate with the new risks, and courts should give the mortgage industry the leeway it needs to implement this equitable formula that gives borrowers who prove worthy throughout the loan repayment the benefit of a lower "crash-free" interest rate.