MetLife Capital — The Uncertain Fate of Default Rate and Late Fee Provisions

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In *MetLife Capital Financial Corp. v. Washington Avenue Associates*,[1] a New Jersey appellate court held unenforceable a late fee fixed as a percentage of the delinquent installment and a default rate that exceeds by 3% the interest rate otherwise in effect under the note.[2] On one level, the decision can be viewed as the just deserts for an overreaching lender and as an admonition to all other lenders against engaging in the egregious conduct of which MetLife was guilty. As legal precedent, which will impact most existing and future commercial lending relationships, the holding is troubling.

MetLife involved a four-year, $1.5 million mortgage loan bearing interest at an annual rate of 9.55% and which provided for monthly installments each in the amount of $14,030.98[3] At maturity, a balloon payment in the amount of $1,391,236.90 was due.[4] The note evidencing the loan provided for a late charge of 5% of the delinquent installment if any payment was more than ten days past due and a default rate of interest equal to the greater of 15% per annum or 5% in excess of the prime rate designated by The Chase Manhattan Bank, N.A.[5]

The defendants made all forty-eight required monthly installments, forty of which were delinquent, but failed to make the balloon payment at maturity.[6] MetLife, therefore, instituted a foreclosure action and exercised its right, under the assignment of leases that also secured the loan, to collect rental directly from the tenant at the mortgaged property.[7] In the suit, MetLife originally sought late fees not only for the forty delinquent monthly installments, but also for the approximately $1.4 million balance remaining at

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[1] 313 N.J. Super. 525, 713 A.2d 527 (App. Div.), *certif. granted*, 156 N.J. 427, 719 A.2d 1025 (1998).

[2] *See id.* at 538, 713 A.2d at 534.

[3] *See id.* at 529, 713 A.2d at 529.

[4] *See id.*

[5] *See id.*

[6] *See id.* at 530, 713 A.2d at 530.

[7] *See MetLife*, 313 N.J. Super. at 530, 713 A.2d at 530.

maturity; this latter claim, totaling almost $69,000, was eventually withdrawn by MetLife.[8] MetLife assessed interest at the 15% default rate and, in calculating the amount due, apparently applied the default rate commencing one month before the loan was in default.[9] Lastly, MetLife asserted a claim to recover the amounts it had advanced for real estate taxes subsequent to the default, together with interest on those advances.[10] Significantly, MetLife found it necessary to advance funds to pay the real estate taxes even though, during the ten-month period in question, MetLife had collected $188,615.50 in rental under the assignment of leases.[11] The explanation for this anomaly was that MetLife had not applied the rentals toward the real estate taxes on the property or toward any of the defendant's other obligations, choosing instead to use those amounts for its own purposes and to credit the defendants with the entire $188,615.50 at or about the time MetLife filed its certification of amount due.[12]

TRIAL COURT RULING

The matter proceeded as an uncontested foreclosure action, subject to an evidential hearing to determine the reasonableness of the late fee and the default rate of interest.[13] Testifying on behalf of MetLife was an investment portfolio manager.[14] She stated that, as a result of late payments, calls are typically made and letters sent to the borrower, reporting and monitoring requirements are triggered, and, presumably, senior management uses the reports generated from these efforts to determine whether to commence litigation or utilize other enforcement techniques.[15] The expert observed further that the 5% late charge was the industry standard and custom.[16] After considering this testimony and the countervailing testimony of the defendant's expert, a bank loan officer, the trial court sustained the late charge as reasonable liquidated damages, but held that a default rate of 15% per annum was in the nature of a penalty.[17] The trial court ruled that a default rate of 12.55%, 3% above the rate otherwise in effect under the note, was reasonably related to actual damages.[18]

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[8] *See id.* at 531, 713 A.2d at 530.
[9] *See id.* at 531-32 & n.2, 713 A.2d at 530-31 & n.2.
[10] *See id.* at 532, 713 A.2d at 531.
[11] *See id.*
[12] *See id.* at 534-35, 713 A.2d at 531-32.
[13] *See MetLife*, 313 N.J. Super. at 530, 713 A.2d at 530.
[14] *See id.* at 531, 713 A.2d at 530.
[15] *See id.* at 539, 713 A.2d at 534.
[16] *See id.*
[17] *See id.* at 531, 713 A.2d at 530.
[18] *See id.*

DECISION ON APPEAL

The appellate division reversed the trial court's rulings regarding the late fee and the default rate.[19] Determining that both provisions constituted liquidated damages provisions, the appellate court applied the two-prong test promulgated in *Westmount Country Club v. Kameny*[20] to assess whether they were enforceable.[21] Under the *Westmount Country Club* test, for liquidated damages to be sustained "(a) the amount so fixed [must be] a reasonable forecast of just compensation for the harm that is caused by the breach, and (b) the harm that is caused by the breach [must be] one that is incapable or very difficult of accurate estimate."[22] As the late charge at issue in *MetLife* was a fixed percentage of the delinquent installment, without regard to the amount of the installment or the number of days it was late, the court concluded that it could not possibly be a reasonable estimate of the administrative costs sustained by MetLife each time a payment was late.[23] The court noted that, "to the extent that these administrative internal costs represent recoverable damages at all, a reasonable liquidated damages provision would have to be in the nature of *a flat fee that would be the same for all borrowers*."[24] However, the court did admit of the possibility that a late fee could vary based upon the frequency and duration of the delinquencies.[25]

The appellate court likewise concluded that the default rate, even as reduced by the trial court to 3% above the contract rate, was a penalty and could not be sustained.[26] Evaluating the testimony of MetLife's expert regarding internal administrative costs resulting from the occurrence of a default, the court concluded that the 3% default rate approved by the trial court was not reasonably related to the damages suffered by MetLife.[27] The appellate court therefore vacated the provisions of the judgment of foreclosure allowing the 5% late charge and the 12.55% default rate of interest, and remanded the case to the trial court with instructions to allow MetLife to present proof of actual damages sustained by virtue of the late payments and the default.[28]

[19] *See MetLife*, 313 N.J. Super. at 545, 713 A.2d at 537-38.
[20] 82 N.J. Super. 200, 197 A.2d 379 (App. Div. 1964).
[21] *See MetLife*, 313 N.J. Super. at 537, 713 A.2d at 533 (citing *Westmount Country Club*, 82 N.J. Super. at 206, 197 A.2d at 382).
[22] *Id.* at 537, 713 A.2d at 533 (quoting *Westmount Country Club*, 82 N.J. Super. at 206, 197 A.2d at 382).
[23] *See id.*
[24] *Id.* at 541, 713 A.2d at 535 (emphasis added).
[25] *See id.*
[26] *See id.* at 544-45, 713 A.2d at 537.
[27] *See MetLife*, 313 N.J. Super. at 545, 713 A.2d at 537.
[28] *See id.*, 713 A.2d at 537-38.

AN ACTIVIST COURT

Based upon the appellate court's ruling, the only way MetLife could receive a fee for the late payments would be to establish the actual damages it sustained.[29] If MetLife is able to do so, that raises the specter that all late charges should be struck down on the theory that actual damages can be proved with precision and without the attendant difficulties that would justify liquidated damages. Although stopping short of that perilous conclusion, the *MetLife* court seemed receptive to that possibility, ruling that "at least some of the legitimate elements of damage are not either unascertainable or difficult to calculate."[30] Alarmingly, support for the court's position came not from the trial record, but rather from the court's gratuitous observation that the late charge was intended to compensate MetLife for the opportunity cost of receiving payments in an untimely fashion.[31] Similarly, the court's conclusions, (i) that coercion was one intended purpose of the late charge, and (ii) that MetLife's internal administrative costs were directly related to the duration and frequency of the delinquencies, were not drawn from testimony adduced at trial but were inferences made by the court.[32] That the decision was grounded in part in the court's unsubstantiated views of commercial lending is an aggressive exercise of judicial license.

Equally flawed is the court's holding that a late charge should be the same for all borrowers. It should have occurred to the court that larger loans constitute a more significant portion of a lender's portfolio and therefore may command more attention than do smaller loans. Assuming that proposition is correct, it follows that a delinquent payment on a $10 million loan may engender more concern and costs than a delinquent payment on a $100,000 loan. Further, different types of loans, by their nature, require varying degrees of oversight and administration; it is not difficult to conceive that a delinquent payment under a mortgage loan may occasion fewer administrative costs than a late payment under a fully monitored, asset-based revolving line of credit with daily reporting of sales and collections. Admitting of these possibilities would militate against the type of per se rule that the court fashioned in *MetLife*.

Another troubling facet of the *MetLife* decision is that the court never ruled on the enforceability of the actual late fee assessed against the borrower. In striking down the late fee provision, the court noted that "the same [5%] applies whether the late installment was $1,000 or $10,000 or

[29] *See id.*, 713 A.2d at 538.
[30] *Id.* at 542, 713 A.2d at 536.
[31] *See id.* at 540, 713 A.2d at 535.
[32] *See id.* at 541-42, 713 A.2d at 535-36.

$100,000 . . . ."[33] However, the installment at issue in the *MetLife* case was not $1,000, $10,000, or $100,000 and did not vary over time; the monthly installment was fixed at $14,030.98 and the late charge, in turn, was fixed at $701.55. Why did the court not rule on the enforceability of that amount as liquidated damages? By hypothesizing about the late fee under circumstances that were not germane to the case, the court promulgated a rule that would also invalidate a late charge equal to one-quarter of 1% of the monthly installment — an amount equal to approximately $35 in the *MetLife* case. Stated simply, the *MetLife* court should have limited its holding to the facts before it, thereby accomplishing justice between the parties and providing guidance to all lenders, without unnecessarily undermining a long-standing industry practice.

MISPLACED RELIANCE

In summary fashion, the appellate division also struck down the default rate on the basis that it could not pass the two-prong test applicable to liquidated damages provisions. The court explained, "On this record, we regard as entirely speculative the conclusion that any unascertainable or difficult to calculate actual damages suffered by MetLife by reason of the default are reasonably related to a 3% enhancement *over the contract rate*."[34] Contrary to the court's reasoning, a default rate is in fact a contractual rate of interest; it is the rate that takes effect from and after the occurrence of an event of default. Loans frequently provide for interest rates to change based upon specific events, such as a borrower's achieving earnings milestones or merely the passage of time. Why, then, did the court in *MetLife* hold that the occurrence of an event of default was an impermissible basis for triggering a change in the interest rate?

In striking down the default rate, the court in *MetLife* blindly applied the liquidated damages test promulgated in *Westmount Country Club*.[35] However, *Westmount Country Club* was a suit to collect annual dues by a country club and is too factually dissimilar to serve as useful precedent in *MetLife*.[36] What the *MetLife* court should have done was examine more closely, and place greater reliance upon, the holding in *Stuchin v. Kasirer*.[37] *Stuchin* was an appeal from a foreclosure judgment upholding a post-default interest rate of 15% in excess of the contract rate of 9%.[38]

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33 *MetLife*, 313 N.J. Super. at 539, 713 A.2d at 534.

34 *Id.* at 545, 713 A.2d at 537 (emphasis added).

35 *See id.* at 537, 713 A.2d at 533 (citing Westmount Country Club v. Kameny, 82 N.J. Super. 200, 197 A.2d 379 (App. Div. 1964)).

36 *See Westmount Country Club*, 82 N.J. Super. at 202-03, 197 A.2d at 380-81.

37 237 N.J. Super. 604, 568 A.2d 907 (App. Div.), *certif. denied*, 121 N.J. 660, 583 A.2d 346 (1990).

38 *See id.* at 610, 568 A.2d at 910.

Although the *Stuchin* court cited the two-prong test from *Westmount Country Club*, it relied primarily upon precedent analyzing default rates under loans.[39] In one case, *Feller v. Architects Display Buildings, Inc.*,[40] the interest rate increased from 17% to 32.87%,[41] and in another case, *Spiotta v. William H. Wilson, Inc.*,[42] the default rate constituted an 8.58% increase in the interest rate.[43] In each of those decisions, the court held the default rate "unconscionable and unenforceable as a penalty."[44] In light of the principles espoused in *Feller* and *Spiotta*, the *Stuchin* court remanded the matter to the trial court to reconsider whether the 15% increase was penal in nature.[45] Should the 3% increase upheld by the trial court in *MetLife* have been viewed in the same vein as the foregoing increases, which ranged from approximately 8.5% to 15%? If not, then *MetLife* represents a radical departure from prior case law addressing the issue.

THE LENDER'S RESPONSE

Unless modified or overturned by the New Jersey Supreme Court, the *MetLife* decision represents the current state of the law and should not be ignored by lenders whose loan documents are governed by New Jersey law. Lenders would be well advised to make an assessment of the internal procedures that are triggered or invoked as a result of a late payment. If guidelines do not currently exist for the procedures to follow once a payment is delinquent, serious consideration should be given to developing written guidelines. Based upon an assessment of those procedures and the costs entailed in implementing them, a late charge should be established. If the internal administrative procedures and related costs warrant, the late fee could be expressed as a per diem amount, on the theory that discrete action is taken daily until the delinquent payment is made. Alternately, the late charge provision could provide that the assessment increases after the passage of a specified interval of time. For example, if a payment were between one and ten days late, one charge would apply, while another charge would be applicable if a payment were between eleven and twenty days late. In any event, the amount of the charge and the basis for increasing it should be reasonably related to the types of administrative procedures and costs that come into play once a payment is delinquent. Finally, it would be

[39] *See id.* at 613, 568 A.2d at 912.

[40] 54 N.J. Super. 205, 148 A.2d 634 (App. Div. 1959).

[41] *See id.* at 213-14, 148 A.2d at 639.

[42] 72 N.J. Super. 572, 179 A.2d 49 (App. Div.), *certif. denied*, 37 N.J. 229, 181 A.2d 12 (1962).

[43] *See id.* at 579, 179 A.2d at 53.

[44] *See Feller*, 54 N.J. Super. at 214, 148 A.2d at 639.

[45] *See* Stuchin v. Kasirer, 237 N.J. Super. 604, 613-14, 568 A.2d 907, 912-13 (App. Div.), *certif. denied*, 121 N.J. 660, 583 A.2d 346 (1990).

prudent to cap the amount of the late charge that could accrue in any one instance, regardless of the number of days a payment is late.

Another option for lenders to consider is abandoning a late charge and, instead, imposing a default waiver fee. Oftentimes, the same delinquency that would render a payment subject to a late charge would also constitute a default under the loan documents. Rather than imposing a late fee, the lender could require the borrower to pay a fee in consideration for the lender waiving the default and agreeing not to accelerate the loan. The process would be effected by means of a default waiver letter in which the borrower agrees to pay the specified sum and releases all claims against the lender up to and including the payment of that amount. It would be difficult to conceive how a court could overturn the payment.

The *MetLife* decision provides little guidance to lenders regarding a default rate of interest. To overcome certain of the objections raised by the court, a lender's loan documents should state that the default rate of interest is a contractual rate of interest, albeit one that applies from and after the occurrence of an event of default. The lender could bolster its position further by requiring the borrower to acknowledge in the note that the default rate is intended to compensate the lender for the risks presented by the loan being in default, including the risk of non-payment. In the event a court were blindly to apply the penalty analysis as did the *MetLife* court, a lender should be prepared to offer more compelling testimony than did MetLife's expert about the types of costs resulting from loans going into default. Those costs may include the expense of having to increase reserves for bad loans and the cost of the lender's credit being downgraded by rating agencies. Lastly, opting for a 2% rather than a 3% increase in the interest rate upon the occurrence of a default would allow another court to distinguish *MetLife* and uphold the default rate.

In dealing with both the late charge and the default rate provisions, full and early disclosure to the borrower is strongly recommended. Just as in the consumer context a credit card company discloses its finance charges and late payment fee in the application, so should a commercial lender alert a prospective borrower to the nature of these charges at the commitment stage. If these charges or fees are fully disclosed prior to the time that a borrower is obligated to proceed with the loan, there is a greater likelihood that those provisions will withstand judicial scrutiny, on the basis that they were bargained-for terms in a commercial transaction. Disclosure is helpful but cannot eliminate all of the uncertainty and risk posed by the holding in *MetLife*.