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NJ Supreme Court Removes Doubt on Late Charges and Default Interest Rates

In a June 30, 1999 decision which was eagerly anticipated by lenders, the New Jersey Supreme Court held that a 5% late charge and a 12.55% default rate (3% above the original contract rate) are reasonable liquidated damages for a default by a borrower on a commercial mortgage. The Supreme Court reversed the well publicized Appellate Division decision of a year earlier. MetLife Capital Financial Corporation v. Washington Avenue Associates L.P. and Lawrence S. Berger v. United States of America (A-34-98). The Supreme Court also recognized the practicality of late charges and default interest provisions and considered the Appellate Division's approach of requiring a lender to prove actual damages on a case-by-case basis to be "economically inefficient or judicially impracticable."

The MetLife case involved a $1.5 million loan secured by a mortgage and security agreement on commercial property located in Belleville, New Jersey. The note provided for 48 equal monthly payments and a final balloon payment due at the end of the 4-year term. The borrower did not make the final balloon payment and was delinquent on 40 of the 48 monthly payments. In addition, the note provided for a late fee equal to 5% of the delinquent payment and, upon an event of default, an interest rate increase to the greater of 5% per annum in excess of the "prime rate" or 15%. Foreclosure procedures were commenced and the trial court held that the lender was entitled to foreclose, that the 5% late fee represented reasonable liquidated damages and that a default rate of 12.55% (3% above the contract rate of 9.55%) was reasonably related to actual damages incurred by the lender.

On appeal, the Appellate Division, to the great chagrin and surprise of commercial lenders, reversed the trial court's decision and held that both the late fee and the default interest rate provisions were unenforceable penalties and that the proper approach would be to require the lender to prove its *actual* damages as a result of the late payments and default.

The Supreme Court reversed the Appellate Division's decision. Of most importance, the Supreme Court observed that liquidated damages provisions in a commercial contract between sophisticated parties are presumptively reasonable and the party challenging the clause bears the burden of proving its unreasonableness. It also used as the basis for its decision (as did the Appellate Division) the "reasonableness" standard as expressed in long-standing New Jersey case law and as codified in the Uniform Commercial Code provision on liquidated damages, adopted in New Jersey as N.J.S.A. 12A:2-718.

The reasonableness standard provides that damages for breach by either party may be liquidated and agreed upon in advance but only in an amount which is reasonable in light of (1) the anticipated or actual harm caused by the breach, (2) the difficulties of proof of loss and (3) the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. The Supreme Court further emphasized that it was the "totality of the circumstances" that affected the validity of a stipulated damages clause.

The Supreme Court found, among other things, the Appellate Division's inference that the 5% late fee had a coercive purpose unwarranted based on the testimony at trial and the Appellate Division's dismissal of the trial court's improper placement of the burden of proof on MetLife contrary to the presumptive reasonableness of liquidated damages provisions. In determining the "reasonableness" of the late charge, the Supreme Court looked at what constitutes common practice in a competitive industry and what is permitted by statute. Uncontradicted testimony by one of MetLife's portfolio Management Specialists provided that a 5% late fee was normal industry custom in similar commercial mortgages.

In addition, the Supreme Court found that both the New Jersey Legislature and the federal government have endorsed late fees based on a percentage basis as well as suggesting that 5% is not an unusually or unreasonably large late fee in commercial transactions. In contrast, the Appellate Division relied on cases involving unusually large percentages or explicit evidence of coercive intent to invalidate the fixed 5% late fee involved in MetLife. Finally, the Supreme Court expressly recognized that the potential damage to lenders resulting from late payment increases as the size of the loan increases. Larger loans will require more intense and expensive supervision and may, therefore, justify larger late charges.

As with the late fees analysis, the Supreme Court emphasized that default interest rates are presumed reasonable and are subject to the reasonableness test. Examples mentioned by the Supreme Court where enhanced rates suggested a punitive intent, and therefore were considered "unreasonable," included an increase of 8.58% (from 30.18% to 38.76%) and 15.87% (increase from 17% to 32.87%). In comparison, the Supreme Court noted, the 3% increase in the MetLife case is a reasonable estimate of the potential costs of administering a defaulted loan and the potential difference between the contract interest rate and the rate that the lender might pay to secure a commercial loan replacing the lost funds.

The New Jersey courts, following the Supreme Court's unanimous decision, should find default interest rate and late charge provisions in a commercial mortgage between sophisticated parties to be "presumptively reasonable" with the burden of proving otherwise placed on the party challenging the provisions, i.e., the borrower. As to what the New Jersey courts will accept as reasonable and enforceable late charge and default interest rate provisions in a commercial loan, a late charge that does not exceed 5% of a delinquent payment and a default interest rate that does not exceed 3% of the original contract rate will more than likely be upheld by a New Jersey court. The door was left open for validating larger late fees and higher default rates if same can be justified on a case-by-case basis under the reasonableness standard.

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