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Not Otherwise in Default

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Everybody knows that prepayment charges are different from late charges. Late charges are often invalid because they are viewed as penalties imposed on tardy borrowers for failing to honor their promises to pay on time. Prepayment charges, on the other hand, are alternative performance clauses, giving the borrower the option of paying ahead of time for some additional cost, and they are generally valid because they are not penalty or liquidated damage provisions.

Even though the legal standards for the two provisions are different, there is enough facial similarity between the acts of paying late and paying early to make confusion between them understandable. (Indeed, an early attempted defense of late charge clauses was that they merely gave borrowers the option of paying on time for one amount or paying afterward for another.) Given that background, can a prepayment charge ever be invalidated as a disguised late charge? If the loan documents permit the borrower to prepay without penalty as long as the borrower has never been late with a payment, is that a valid prepayment clause or an invalid late charge clause?

The **Ridgley v Topa Thrift** Disagreement

This predicament was addressed in *Ridgley v Topa Thrift & Loan Ass’n* (review granted July 9, 1997, S061765; superseded opinion at 53 CA4th 1177 (advance reports), 62 CR2d 309, reprinted as modified at 54 CA4th 729 (advance reports)), reported at 20 CEB RPLR 137 (May 1997). In *Ridgley*, the note provided that the prepayment charge would be waived after the first six months of the loan “provided that there [had] been no other defaults.” Thirteen months later, the borrower missed a payment, but he sold the property the next month and paid off the loan entirely. (The pending sale was the cause of the missed payment and the lender waived the late charge for it.) Because of that missed payment, however, the lender then imposed a $115,000 prepayment charge.

As a prepayment issue, six months’ advance interest on a $2.3 million loan is perfectly appropriate. On the other hand, a charge of $115,000 for being late with a monthly payment of $19,500 has no chance whatsoever of being upheld. So which was this?

For the appellate court majority, the provision was merely a prepayment charge, no less valid because under other circumstances it was waivable: “[I]f the provision had stated the penalty would be imposed if there was a prepayment, the provision would have been valid. We conclude the provision was not made invalid by conditioning a waiver upon a lack of default.” 54 CA4th at 738. For the dissent, however, this was not a charge for prepayment because the lender, by its willingness to waive it after six months, “was saying that it would recover enough in interest payments during that period to compensate fully for lost future interest payments as well as the administrative costs of negotiating this loan and then replacing it with a new loan from another borrower for whatever term remained on this loan.” 54 CA4th at 743. The fact that the clause imposed a fee only if there was a default thereafter made it fall “squarely within the definition of a penalty or forfeiture which is invalid unless proportionate to the damages sustained.” 54 CA4th at 743.

The forcefulness of the dissent reduced the comfort that drafters could take from the majority’s opinion, and now the supreme court has granted a hearing on the matter, which leaves us all in the dark for the while. Perhaps the high court’s decision will be confined to the technical prepayment/late charge debate, but it could also trigger a much broader debate among the justices.
**Freedom of Contract or Debtor Protection?**

The issue raised by this clause is not one of drafting; in fact, it arises only when the clause is drafted clearly enough that it plainly applies to the transaction. The issue is whether judges will permit the clause to operate as it is worded—*i.e.*, whether they will look at its form and see it merely as a clause that imposes limits on a borrower’s right to voluntarily elect prepayment—or whether they will focus on its economic effect (*i.e.*, its substance) of imposing a large additional cost on a borrower for making a late payment. That is really a question as old as mortgage law itself.

The earliest mortgages gave the lender a present defeasible title (fee simple subject to the condition subsequent of payment by the borrower), meaning that nonpayment on the due date enlarged the lender’s title into a fee simple absolute automatically, instantaneously, and finally. It was only after chancery courts created the equity of redemption that debtors got the right to pay late, a right that had nothing to do with the language of the instrument. California Mortgage and Deed of Trust Practice §1.21 (2d ed Cal CEB 1990). To protect that right, the corollary rule against clogging had also to be imposed, prohibiting the mortgage from including provisions that waived or impaired the right of redemption. Thus, judges outlaw a lot of clauses. However, to decide whether a clause is or is not a clog isn’t easy; it requires some kind of economic analysis of the provision, and that gets you on the slippery slope from prepayment to late charge clauses.

If a deed of trust says that upon the trustor’s failure to make any installment payment on time the entire loan is entirely due, with no right of reinstatement, it is invalid. If it states that the loan is for two months, but may be renewed for an additional month thereafter if some payment is paid no later than the last day of the month, is that also an improper waiver of the right of reinstatement, or is it the legitimate denial of the conditional privilege of renewing the loan? How does a court distinguish between a permitted denial of benefits and a prohibited imposition of burdens? There can’t be a simple answer to that question or else every drafter would know how to get on the good side of the distinction.

Furthermore, judicial protection is intermittent; a court first has to perceive that a mortgage is involved, and also has to conclude that the provision involved is unfair (a clog) despite its wording. Artful drafting (as often occurs with sale-leasebacks and other disguised loan transactions) may keep judges from realizing that they have a mortgage in front of them, and can mask the clogging effect of the clauses contained in the document. Prospects are not bright once the judges know the document is a mortgage and the clause exacts a penalty.

In that respect, the outlook is ominous for the *Ridgley* lender. The clause it employed made its effect depend on whether there was any “default,” a word which is a red flag to those concerned with penalties. Civil Code §2906, for instance, says that an option for the mortgagee to purchase the mortgagor’s property does not impair the equity of redemption only if it “is not dependent upon the occurrence of a default.” With a statutory warning like that, a prepayment provision written to be dependent on default is just asking for trouble. (Especially because a borrower in bad standing is just the kind a lender ought to want to see paying off the loan early!)

**Effect of Tying Everything Together**

The “not otherwise in default clause” is now in common use in commercial documents. Numerous benefits and burdens are imposed on one or both parties, and cross-default and cross-acceleration clauses are included so that rights and duties are tied together in ways no one may have anticipated. Provisions such as partial releases of acreage from blanket loans, further draws on lines of credit, and options to renew (in loans, leases, or other transactions), to name just a few, are reflexively made dependent on the absence of defaults in any other respect. That can easily lend itself to judicial invalidation of any attempted withholding of a concession following
an unconnected default on the ground that it is really a disguised penalty rather than a conditionally withheld benefit.

For now, attorneys should be cautious in assuring their clients that such clauses may not always work. They should be even more cautious in interlocking all the provisions of a deal into one big package. (At the very least—as Pat Randolph, the ABA’s Reporter on California Real Estate Decisions, has proposed—defaults should be tied only to arrangements that will endure thereafter, and not to terminating provisions of the loan.) Most of the time these interlocks are not truly negotiated or really necessary; they are boilerplate that the word processors, rather than the lawyers, added into the documents. Like the old dragnet clauses that went too far and then bit back, these blanket clauses may not give the lenders what they really want.