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December 9, 2022

Hon. Chief Justice of California
Hon. Associate Justices of the
California Supreme Court
350 McAllister Street
San Francisco, CA 94101

Re: *Honchariw v. FJM Private Mortgage Fund*, S277159
Letter in Support of Petition for Review, Cal. R. Ct. rule 8.500(g), or, in the Alternative, Request for Depublication

Honorable Justices:

As amicus curiae, the California Bankers Association ("CBA") submits this letter in support of Respondent, FJM Private Mortgage Fund, LLC's petition to review the Court of Appeal's published decision in *Honchariw v. FJM Private Mortg. Fund, LLC* (2022) (Case No: A163756, September 29, 2022) 83 Cal.App.5th 893.

INTEREST OF AMICUS CURIAE

Established 130 years ago, the CBA is one of the largest banking trade associations in the United States, advocating on legislative, regulatory, and legal matters on behalf of banks doing business in California.

The CBA actively assists courts in addressing significant legal interests by appearing as amicus curiae before state and federal appellate courts on various issues. In addition, the CBA provides its members with developing relevant legislative and educational solutions to California's pressing financial and banking issues. The CBA provides its members with specialized continuing education, representation in legislative

matters, and multifaceted support by providing a forum for exchanging ideas facing the financial services industry.

The CBA's members are directly and adversely impacted by the Court of Appeal's published decision in this case. Its members' loans regularly include default interest provisions. Although this action involved private money lenders, the appellate court's decision is not limited to such loans. Instead, the court broadly held that the imposition of default interest on the outstanding principal balance of a non-consumer, "partially matured" loan constituted an unlawful penalty. (*Honchariw,* 83 Cal.App.5th at p. 905.)

ISSUES PRESENTED

The fundamental issue is whether the assessment of default interest against the entire outstanding loan balance until the default has been cured or the unmatured note has been paid in full constitutes an unlawful penalty under Civil Code section 1671 ("section 1671"), even when the parties expressly agreed in the loan documents that FJM Private Mortgage Fund, LLC ("FJM"), as a lender, would incur difficult-to-estimate expenses as a result of the default. FJM's petition for review broke these issues into two parts, stating:

1. Whether section 1671 requires consideration of all the circumstances surrounding the creation of a contract containing a liquidated damage clause, or only the measure of actual damages, in evaluating enforceability.

2. Whether section 1671 expresses a public policy that liquidated damages must bear a reasonable relationship to the actual damages.

As explained below, this Court's review of the Petition is necessary to secure uniformity of decision and to settle important questions of law under Rule 8.500(b)(1) of the California Rules of Court.

REASONS WHY REVIEW SHOULD BE GRANTED

A. Background

Nicholas and Sharon Honchariw (collectively, "Appellants") defaulted on a $5.6 million non-consumer loan secured by real property by missing one monthly payment of $39,667. (83 Cal.App.5th at p. 898.) Upon default, FJM invoked a late payment provision in the loan agreement that included a one-time 10 percent fee assessed against the

overdue payment and a default interest charge of 9.99 percent per annum (collectively, the "Late Fee") assessed against the total unpaid principal balance of the loan. (*Ibid*.) Appellants commenced arbitration, contending, among other things, that the Late Fee constituted an unlawful penalty in violation of section 1671. (*Ibid*.) The arbitrator disagreed and upheld the validity of the penalty in an arbitration award ("Award"). Appellants petitioned to vacate the Award. After the trial court denied this petition, Appellants appealed the judgment confirming the Award. (*Ibid*.)

The Court of Appeal reversed, holding that the imposition of the Late Fee against the loan's entire unpaid balance of a "partially matured" loan constituted an illegal penalty contrary to "well defined and dominant public policy" established in section 1671. (83 Cal.App.5th at p. 899.) The court recognized that a liquidated damages clause is presumed valid under section 1671 if it is in a non-consumer contract. (*Id*. at p. 900.) While recognizing this principle, the court relied on *Garrett v. Coast & Southern Fed. Sav. & Loan Assn*. (1973) 9 Cal.3d 731 and adopted a per se rule that turns this presumption on its head. The court ruled that under *Garrett*, any "late payment measured against the unpaid balance of a loan must be deemed punitive" because "it is an attempt to coerce timely payment by forfeiture which is not reasonably calculated to merely compensate the injured lender." (*Honchariw,* 83 Cal.App.5th at p. 901.) The court reiterated its per se rule at the end of its opinion, stating: "Put another way, by its very existence [the Late Fee], the Honchariws have met their burden of showing an unlawful penalty. (*Id.* at p. 906.) Despite this ruling, the court found that there was no "reasonable relationship" between the Late Fee and the range of actual damages that the parties could have anticipated would flow from a breach of the loan documents despite language in the loan documents, in which the parties acknowledged that FJM would incur "difficult-to-estimate expenses" because FJM would incur additional expense in serving a defaulted loan and would lose the use of the money due, thereby necessitating the imposition of the Late Charges. (*Id*. at p. 904, n. 7.)

B. The Court of Appeal's Published Decision Misapplies Section 1671(b) By Improperly Relying Upon *Garrett*

Since its inception, California law has addressed the validity of liquidated damages provisions. In *Nash v. Hermosilla* (1858) 9 Cal.584, this Court defined liquidated damages, stating: "When the party [to a contract] stipulates to pay a stated sum for a given period of time during the continuance of the failure, then the damages are to

be considered as liquidated."[1] "When the agreement is not to carry on trade at a particular place; not to run a stage-coach on a particular road; not to publish a rival newspaper; not to run a rival steamer on a particular route. In all these cases, the sum stated must be taken as liquidated damages." (*Id*. at p. 587.) An invalid and unenforceable liquidated damage provision constitutes a "penalty." (*Fisk v. Fowler* (1858) 10 Cal.512, 517; see *McGuire v. More-Gas Investments, LLC* (2013) 220 Cal.App.4th 512, 521.)

In 1872, California enacted former Civil Code section 1670, which provided that a liquidated damages provision was "void" unless it complied with former Civil Code section 1671, which, in turn, provided, "The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damages." (*Utility Consumers' Action Network, Inc. v. AT&T Broadband of Southern Cal., Inc.*. (2006) 135 Cal.App.4th 1023, 1028-1029.)

In 1973, this Court interpreted former Civil Code sections 1670 and 1671 in *Garrett v. Coast & Southern Fed. Sav. & Loan Assn.* (1973) 9 Cal.3d 731. At issue in *Garrett* was a charge for late payment of a loan installment. The *Garrett* court began its analysis presuming that the liquidated damage provision was invalid, noting that the party seeking to rely on a liquidated damage clause bears the burden of proving its validity. (*Id*. at 738.) To rebut this presumption, the *Garrett* court required that a party demonstrate that the liquidated damage amount represents "the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained." (*Ibid*.) With this framework, the *Garrett* court was "compelled to conclude that a charge for the late payment of a loan installment which is measured against the unpaid balance of the loan must be deemed to be punitive in character. It is an attempt to coerce timely payment by a forfeiture which is not reasonably calculated to merely compensate the injured lender." (*Id*. at p. 740.) The court held that the charge for late payments was "void" because "*the parties* failed to make a reasonable endeavor to estimate a fair

[1] In more recent times, courts adopted this definition of "liquidated damages" as meaning the "amount of compensation to be paid in the event of a breach of contract, the sum of which is fixed and certain by agreement, and which may not ordinarily be modified or altered when damages actually result from nonperformance of the contract." (*JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC* (2022) 80 Cal.App.5th 409, 420; *McGuire v. More-Gas Investments, LLC* (2013) 220 Cal.App.4th 512, 521.)

compensation for a loss which would be sustained on the default of installment payment." (*Ibid*., emphasis added.)

In 1977, the Legislature adopted a California Law Revision Commission Report ("Report"), without change, recommending repeal of former section 1670 and revisions to section 1671.[2] (9 Cal.3d at p. 1029.) The Report detailed the relevant changes to section 1671. "Law Revision Commission comments are entitled to great weight in construing statutes proposed by the commission and adopted without substantial change." (*Pac. Tr. Co. TTEE v. Fid. Fed. Sav. & Loan Ass'n* (1986) 184 Cal.App.3d 817, 823.) The Report determined that the liquidated damages provision "must reflect" a reasonable endeavor to estimate damages. Relying on this Court's decision in *Better Food Markets, Inc. v. American Dist. Tel. Co.* (1953) 40 Cal.2d 179, 187 (*Better Food*), the Report noted this requirement could be satisfied by a standardized, non-negotiated contract. (9 Cal.3d at p. 1029.) In doing so, the Report deliberately excluded any requirement *by the parties* to expressly negotiate the amount of liquidated damages provisions. (*Id*. at p. 1029, 1035-1036.) The court in *Utility Consumers' Action Network* exhaustively examined the Report's analysis of this point. (*Ibid*.) With this framework, the Legislature adopted a revised section 1671, subdivision (b) that made liquidated damage provisions *presumptively valid* in non-consumer cases, stating:

> (b) Except as provided in subdivision (c), a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.

(Civ. Code, § 1671, subd. (b); Stats. 1977, ch. 198, § 5, operative July 1, 1978.)

In this case, the Court of Appeal built its decision on the per se rule adopted under *Garrett,* observing that "*Garrett* remains good law for the proposition that a late fee assessed against the entire unpaid balance of a loan constitutes an unlawful penalty." (*Honchariw,* 83 Cal.App.5th at p. 902.) In doing so, the court went a step further,

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[2] In response to *Garrett*, the Legislature also enacted Civil Code section 2954.4, which limits the amount that may be charged as a late fee on a delinquent home loan to 6 percent of the installment applicable to the payment of principal and interest on the loan or five dollars, whichever is greater. (See *Walker v. Countrywide Home Loans, Inc*. (2002) 98 Cal.App.4th 1158, 1171.)

effectively adopting the analysis of *Garrett* and finding that FJM must prove that *the parties* negotiated the range of actual damages flowing from missed installment, which was expressly rejected in the Report in revising section 1671(b). (*Id*. at p. 903-904.) The Court of Appeal rejected the standardized language in the loan documentation that FJM would incur difficult-to-determine expenses due to a default, which contravened the Report's acceptance of the analysis in *Better Food.* (*Id*. at p. 904.) If permitted to stand, the Court of Appeal's decision would contravene the Legislature's revisions to section 1671 in 1977 and the analysis outlined in the Report. In short, it would change the presumption on a liquidated damages provision for a non-consumer contract from presumptively valid to presumptively invalid when default interest is charged on a matured loan. This per se rule would prevent assessment of default interest regardless of the default interest rate, the prior notice or opportunity to cure before assessment of the default interest, or the circumstances under which the lender assesses default interest.

The CBA concurs with FJM that this case presents a substantial question of law and requires consideration to secure a uniformity of decision. FJM relied upon *Gormley v. Gonzalez* (2022) 84 Cal.App.5th 72 to establish the need for uniformity to request consideration of its Petition. The *Gormley* decision was subsequently depublished. However, the need for a decision by this Court remains. The applicability of *Garrett* and the Legislature's intent in revising section 1671 must be clarified and resolved to establish uniformity and consistency.

Default interest provisions are found in virtually every promissory note and serve fundamental purposes in the lender-borrower relationship. The assessment of default interest recognizes the increased risk associated with a defaulted loan, the additional expense of servicing a defaulted loan, and the lost investment opportunity costs due to missed payments. While providing an incentive for a borrower to cure a default, it serves as an incentive for lenders to forgo immediate foreclosure because they are being compensated for the increased risk. With rising interest rates (the Prime Rate is at 7 percent as of November 2, 2022) and with most outstanding loans at historically low rates (i.e., the Prime Rate equaled 3.25 percent as of March 16, 2020), the inability to charge default interest on an unmatured loan may create a financial incentive to foreclose on borrowers, rather than enter into forbearance agreements. With a looming recession, the per se rule in this case may lead to a swell in foreclosures.

In short, reasonable default interest provisions benefit both borrowers and lenders. They reduce foreclosures, facilitate loan workouts and ensure access to capital by compensating for the augmented risks and costs associated with defaulted loans.

CONCLUSION

The CBA respectfully requests that this Court grant review of the Petition to secure uniformity and settle the critical questions of law posed in this case. As FJM aptly points out in its depublication request, the Court of Appeal's reported decision in this case unnecessarily creates conflict and uncertainty in this area of law which the Legislature acted to clarify. If a review of the Petition cannot be granted for any reason, this Court should depublish the Court of Appeal's opinion.

Very truly yours,

BUCHALTER
A Professional Corporation

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