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LENDING: BALLOON PAYMENTS AND LATE FEES

In the lending and credit industries, loan agreements routinely require borrowers to pay late fees for missed payments. But a recent decision from the Arizona Court of Appeals – *Dobson Bay Club II DD, LLC v. La Sonrisa De Siena, LLC*, No. 1 CA-CV 13-0709 – will have an adverse effect on the enforceability of certain late fees. Going forward, lenders in Arizona are generally prohibited from charging late fees on balloon payments.

The facts in *Dobson Bay* were relatively straightforward. The Bank issued a $28.6 million loan secured by four commercial properties in Maricopa County that Borrower acquired using the loan proceeds. The loan had conventional terms: monthly payments of accrued interest, with a balloon payment at the end of the term equal to the outstanding principal balance. For any missed payments—including the balloon payment—Borrower agreed in the loan documents to pay a late fee equal to five percent of the unpaid sum. The loan documents also required Borrower to pay, following an event of default, a higher interest rate and Bank's legal fees and collection costs.

Borrower and Bank were unable to negotiate an extension, and the loan went unpaid at maturity. Bank provided a payoff statement reflecting the principal balance, plus regular interest, default-rate interest, a late fee equal to five percent of the balloon payment, and legal expenses. Before Bank could foreclose, Borrower obtained new financing and paid the outstanding balance. But Borrower disputed the payoff amount, and litigation ensued over whether Bank could keep the late fee.

Under Arizona law (even prior to *Dobson Bay*), courts distinguish liquidated damages from penalties. Liquidated damages are enforceable; contractual penalties are contrary to public policy and void. To qualify as liquidated damages, the specified amount must provide a reasonable forecast of the anticipated loss caused by a breach, and that loss must be difficult to quantify. Conversely, if there is no actual loss, or if the actual loss is both easily quantified and not commensurate with the liquidated damages, then the prescribed amount is considered a penalty.

After reiterating and refining these basic principles, the court in *Dobson Bay* applied them to late fees. Bank argued that late fees compensate lenders for a variety of losses, which include losing the ability to reinvest the expected but missing payments, having to pay loan officers to give additional attention to troubled loans, and facing decreased lending limits or additional regulatory oversight. The court was not convinced. The three-judge panel concluded that such damages are already covered by the interest rate, default interest, foreclosure of collateral, late fees on installment payments, and various other terms. According to the judges, to also impose late fees on a balloon payment was punitive.

Bank also argued that the late fee was fully negotiated between two commercial parties, both represented by attorneys, and that courts should not infringe on their right to contract freely. The court rejected this argument as irrelevant under Arizona law. Regardless of the borrower's bargaining power or level of sophistication, contractual penalties are simply unenforceable.

The opinion in *Dobson Bay* concluded as follows: "Absent unusual circumstances, the imposition of a flat 5% late fee on a balloon payment for a conventional, fixed-interest rate loan is not enforceable." The court noted that unusual circumstances may exist to justify late fees as liquidated damages. The court also tacitly approved late fees on periodic installment payments. But lenders in Arizona are now generally prohibited from charging late fees on balloon payments. If such fees are an important aspect of the lending decision, lenders will need to be creative in structuring their loans, such as by increasing default-rate interest or other charges.

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