

# FLAG ON THE PLAY!

## PENALTIES, LATE CHARGES AND ATTORNEY'S FEES IN ARKANSAS

by W. Christopher Barrier

**P**enalties on the diamond, gridiron, court or rink are intended to discourage undesirable behavior, from delay of the game to spearing with a hockey stick. In the legal context, penalties of various kinds may have that same purpose, but they can also serve to compensate for losses. They are not favored by the courts and, hence, they may be enforceable or not, depending on which purpose is ascribed to them by the judicial referee.<sup>1</sup>

In a period of rising rates of loan default, especially loans secured by real estate, lenders do not often have the luxury of worrying about collecting the penalties represented by late fees or legal fees or pondering legal theory. However, because these fees can become an issue in workouts and takeouts and lenders, borrowers and especially lawyers need to know the rules before they take the field. Cross-training in other areas can also provide useful conditioning.

### Offensive holding...

The most troublesome situation regarding penalties arises in takeouts of delinquent loans, especially those that have matured. Suppose you as lender hold a note with a \$1,000,000 principal balance that calls for a late payment penalty of five percent of past due installments and the note balloons without being paid off. Late charges on monthly installments may be less than \$200 each, while the ballooned default in this case may call for a penalty of \$50,000.

No problem. It's negotiable and having the penalty in place makes a handy pry pole for settlement, right? Maybe. Suppose the borrower has obtained a takeout lender for the entire balance, probably through a sale of a portion of the encumbered assets. Suppose also that the borrower has accepted the increase in the interest borne by the loan after default and is also prepared to reimburse the lender every cent of its out of pocket expenses, all of which are verifiable—but *none of the late payment penalty*.

Suppose finally that the borrower says his sale will crater if he has to come up with much additional cash—and you have reason to believe that is actually true. Where does that leave your lender's lawyer in terms of (a) *your negotiating position*, and (b) *possible lender liability*?

### Hard times mean tough calls...

Well, first keep in mind that the issue also can come up in the context of *deeds in lieu of foreclosure*, when the tendered property satisfies only *part* of the debt and there is a *workout* for the rest. How that remaining balance is calculated may turn on the inclusion

or exclusion of late charges, especially if late charges for more than one monthly default have been included.

It also can come up in utilizing *non-judicial foreclosure*. The terms of that statute—especially as to minimum bid amounts, distribution of proceeds, amounts needed to reinstate and calculation of deficiencies—arguably *do not include late penalties*, monthly or otherwise, in the process at all unless they represent *actual* collection costs.<sup>2</sup> So, don't be caught off-sides.

### Gentlemen, this is a football...

Again, resolving these issues in each of these contexts depends in part on understanding the *nature* of late charges and penalties. Despite the use of the term "penalty," late charges are in fact intended as a type of liquidated damages and not as a means for penalizing (i.e., punishing) the shortcomings of the borrower. They are included in contracts to be payable on a default, such as not making a monthly payment within the grace period permitted in the documents. They are intended to approximate the *extra effort and expense* expended by the lender in collecting past due payments. Attributing a specific amount of collection expense to the collection of one isolated, discrete loan payment is really not practical, so the parties may agree to a standard late fee of perhaps five percent of the overdue payment.<sup>3</sup>

The classic liquidated damages situation occurs in *contracts to purchase real estate*. Should a buyer refuse to go through with a purchase for which he has contracted, the buyer may rightly insist that damages are inappropriate at the time, because the seller *has not been damaged*—she still has a property which is worth the purchase price, so she is just as well off as she was before. On the other hand, if the seller can prove the agreed price was actually *greater* than the parcel's fair market value at the time of the default, the buyer has some exposure.<sup>4</sup>

### Forfeit the game?

To avoid the argument over value, the parties may agree on earnest money which can be forfeited and treated as a reasonable *approximation* of the *damage* caused by the breach. Real estate contracts frequently provide that the seller's acceptance of the earnest money does *not* preclude him from seeking "actual" damages—but legally it *does*.<sup>5</sup> Likewise, if the earnest money is *significantly more than the local standard*, can the buyer argue that at least *part* of the earnest money represents punishment rather than legitimate compensation? Probably so.



In any event, in the lending context, where the borrower can indeed document the *actual expenses* of the lender, can the lender collect *any* of the penalties called for by the loan documents, especially if the penalty relates to the balloon, not a monthly payment? Yes and no.

#### Tell it to the ref...

*Penalty interest* at a rate which would have been legal at the time the note was signed, due to the default, has become interest on a short-term note with an uncertain pay-off date, which arguably can justify a higher rate. Also, in some notes, rates may rise (or fall) according to an outside index. A rate which rises due to the borrower's own behavior seems at least as reasonable. So that is very likely collectable in Arkansas.

However, there are commentators who note that many states require default interest to not only be legal, but also "reasonable."<sup>6</sup> Those same commentators also argue that "reasonable" is too restrictive a standard, and that only "unconscionable" rates should be prohibited. In the commercial context in Arkansas, borrowers typically negotiate default interest rates that don't even come near the "unconscionable" strike-zone.<sup>7</sup>

However, others let slip through the loan documentation process penalty interest "at the highest rate allowed by applicable law." Due to federal preemptions, that may mean *no ceiling at all*.<sup>8</sup> If litigated, the likely outcome would be a rate that meets the "reasonable" test, *not* the "unconscionable" measure, given judicial antipathy to penalties. That is almost a certainty if the loan has come due because the lender has the right to call it for any reason, not just on default.<sup>9</sup>

#### Don't rough the kicker...

Lenders frequently coordinate pay-offs of existing loans with the making of new loans, since they want to keep their funds invested as productively as possible. Further, they could expend time, expense and effort on underwriting loans that don't get made because the funds weren't available due to another borrower's default. So a penalty in *some* amount, and related to the amount of the balance, may actually represent a variety of liquidated damages. But, on a loan of any size, that lost-opportunity expense is more likely to fall in the one-two percent range than the five percent.<sup>10</sup> So, lenders should not push it, as a matter of negotiation.

On the other hand, is it dangerous to *even include* late penalties in loan documents if they may not be enforceable? No. In the first place, *some portion* of the late fee can almost always be justified as

liquidated damages, especially the monthly late fees. Secondly, as to lender liability, the situation is *not* the same as when an employer seeks to enforce a clearly invalid covenant not to compete against a former employee.<sup>11</sup> In the latter case, a person's ability to earn a living is at issue, not dollars and cents, and bargaining power is significantly out of balance. In the current climate, worthy borrowers may frequently call at least as many plays as their lenders.

#### Delay of the game...

If a borrower is three months late when the lender declares a default, can the lender require payment of *all three* late charges as a condition to reinstatement? It will usually take more time, effort and expense to collect three past due payments than just one. So multiple charges arguably can be justified. However, that is no slam dunk.<sup>12</sup>

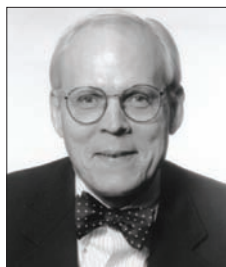
Having to pay the opposing team's *legal fees* can certainly be more painful than other penalties and provisions calling for their award that are common in all manner of documents, from notes to bills of assurance. In particular, the documents often call for reimbursement of legal fees if legal action is needed to enforce the document.

#### Stay in the strike zone...

For the first half of my legal career, absent a few specialized areas, the only contractual documents whose breach could occasion assessment of attorney's fees were promissory notes. Ark. Code Ann. § 4-56-101. No drafting around it.

Since 1989, virtually *any contract* (even open accounts and including leases)<sup>13</sup> may provide for an award of attorney's fees to the enforcing party, at the trial court's discretion. Ark. Code Ann. § 16-22-308—just the opposite of Ark. Code Ann. § 4-56-101 (and the common law).<sup>14</sup>

Under this section, if the parties want to go back to each party



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attorney’s fees. Solid waste late fees are also collectable because of statutory authorization.<sup>22</sup>

#### **Pre-pay or punt...**

Pre-payment penalties are another matter, and typically are justified on two grounds. First, as a matter of contract, a lender almost certainly can *prohibit prepayment altogether*, so allowing it only on certain conditions is no stretch. And a penalty with at least some relation to maintaining the lender’s return on the investment represented by the note is clearly reasonable, not punitive.

However, when a note has been prepaid from the proceeds of a foreclosure sale, adding the penalty may look to the courts like piling on, which may also be the case with prepayment from insurance proceeds.<sup>23</sup>

#### **Clear play-calling needed...**

By the way, if a lender intends to prohibit prepayment altogether, it needs to say so. A note whose installments are payable “on or before” each payment date is pre-payable, although the lender may attempt to argue that the interest may also need to be prepaid.

In some instances, *statutes* may alter the bargaining rights of the parties regarding pre-payment. Lenders may not impose prepayment penalties on loans secured by farm land that are harsher than those set forth in Ark. Code Ann. § 23-32-203, unless the parties waive its application in a specific way.

However, the calculations required by this statute are impossible to apply, so no lender should fail to get the waiver, even when using a version of this statutory formula. Otherwise, the lender risks a healthy penalty if it is found to have read the statute incorrectly.

#### **Defend your position...**

As suggested previously, penalties have to be wrestled with and justified in non-lending real estate transactions as well, notably charges for late rent payments and forfeiture of earnest money. Upping the rent for holding over after a lease has expired looks more like penalty interest, given its impact on efforts to re-let the space, than an arbitrary penalty, which may make it justifiable, but courts are hostile to the notion.<sup>24</sup>

Use of penalties (like sports metaphors) has crept over into venues divorced from lending or leasing. Property owners associations (POA) may well take advantage of Ark. Code Ann. § 16-22-308 to collect overdue assessments, although that is not clear. However,

paying their own fees, or dividing them equally, they have to *say so*.

Workout negotiators need to remember both that discretionary feature of the statute and the optional one, and also a few other rules of construction. In *Asbury Auto. Used Car Center v. Brosh*,<sup>15</sup> the contract contained (a) an arbitration clause, (b) a severability clause, and (c) a fifty-fifty expense clause in any such arbitration. (So far, so good.)

*But*, the arbitration clause was struck for lack of mutuality, and the court would not sever the 50-50 piece out of the wreckage and apply it to litigation. Contractual terms spelling out provisions for attorney’s fee awards are enforceable as written (but not re-written).<sup>16</sup>

The Arkansas Residential Landlord – Tenant Act of 2007<sup>17</sup> has a rather elaborate structure as to leases coming within its terms (which, despite the title, includes commercial leases).<sup>18</sup> Regarding awards of attorney’s fees (primarily in landlord claims of default), a tenant’s only defense to such an award is a good faith claim that the landlord’s demand is factually or legally incorrect.<sup>19</sup>

#### **Unintentional grounding...**

So, what other causes of action are left that *cannot* include awards of attorney’s fees? Well, most torts and other debts and claims not arising in a contract or lease context, and without *some* statutory hook. Interestingly, recovery of legal costs has been permitted with regard to collection of condominium fees even without the benefit of Ark. Code Ann. § 16-22-308.<sup>20</sup> By statute, condominium bylaws “must necessarily” set forth the manner “of collecting from co-owners” for “common expenses.”<sup>21</sup> Such bylaws, under Ark. Code Ann. § 18-13-116(a)(i), may provide for collection of “any other expenses lawfully agreed upon...” which the *Damron* case declared to include

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their documents also call for penalties in hopes of modifying behavior of home owners, but POAs frequently confuse the penalty box kind with the liquidated damages variety.

Specifically, they may also attempt to fine behavior, from back yard goat roasts to maintaining weed lots, in which case there is really no way to measure the impact on property values of those transgressions. And what is an “appropriate” penalty may be a really tough call at the line of the scrimmage.

**Conclusion:** Before insisting on a significant late charge, as to loan payments, rent or POA assessments, the collecting entity should compare the charge to actual expenses and lost-opportunity costs that can be reasonably estimated and should also remember judicial hostility to penalties generally.<sup>25</sup>

Earnest money forfeiture amounts should make sense as liquidated damages. Lenders should not lose desirable workouts over unreasonable fees. All need to be sure their demands for attorney’s fees have a statutory basis. All can contract for penalty interest if the rates are legal, but not without some limits. Lenders should not be buffaloed by lender liability trash talking. And all should take care to distinguish spirited play from unnecessary roughness.

**Endnotes:**

1. *Canadian Mineral Co. v. Creekmore*, 226 Ark. 980, 984, 295 S.W.2d 357, 360 (1956); *Cooley v. Lovewell*, 95 Ark. 567, 568, 130 S.W. 574 (1910); *Bright v. Glass*, 38 Ark. App. 71, 80, 831 S.W.2d 149, 155 (1992).
2. ARK CODE ANN. §§ 18-50-101, *et. seq.*, especially §§ 107, 109, 114.
3. *Metlife Capital Fin. Corp. v. Wash. Ave. Assocs.*, 159 N.J. 484, 732 A.2d 493 (1999).
4. *McGregor v. Echols*, 153 Ark. 128, 239 S.W. 736 (1922).
5. *Hearrell v. Rogers*, 7 Ark. App. 230, 646 S.W.2d 703 (1983).
6. Steven W. Bender & Michael T. Madison, *The Enforceability of Default Interest in Real Estate Mortgages*, 43 REAL PROP. TR. & EST. L.J. 199, 202, 204 (2008).
7. *Ibid.*
8. 12 U.S.C.A § 1831u(f) (West 2009).

9. ARK CODE ANN. § 4-3-108 sets out the rules of the game here.
10. Interview with Arkansas banker.
11. *Stebbins & Roberts, Inc. v. Halsey*, 265 Ark. 903, 582 S.W.2d 266 (1979).
12. *Tackett v. First Savings of Ark.*, 306 Ark. 15, 22, 810 S.W.2d 927, 931 (1991).
13. *Sunbelt Exploration Co. v. Stephens Prod. Co.*, 320 Ark. 298, 896 S.W.2d 867 (1995).
14. *Murchie v. Hinton*, 41 Ark. App. 84, 848 S.W.2d (1993).
15. 364 Ark. 386, 220 S.W.3d 637 (2005).
16. *Griffin v. First Nat’l Bank*, 318 Ark. 848, 888 S.W.2d 306 (1994).
17. ARK CODE ANN. § 18-17-701 *et seq.*
18. ARK CODE ANN. § 18-17-708.
19. You must pay the rent.
20. 295 Ark. 533, 750 S.W.2d 402 (1988).
21. Ark. Code Ann. § 18-13-108(b)(4).
22. *Freeman v. Curry*, 299 Ark. 263, 772 S.W.2d 586 (1989).
23. Surprisingly, there is almost no case law on point. A *deliberate* default to avoid a high interest rate, and with a new lender in the wings, may be an exception, but the prevailing legal philosophy exemplified by the Arkansas cases cited in this article would seem to discourage the extra hit as to a genuinely distressed borrower, and even more so an involuntary casualty loss.
24. *Moll v. Main Motor Co.*, 213 Ark. 28, 210 S.W.2d 321 (1948).
25. The reasonableness of the approximation is crucial. *Johnson v. Jones*, 33 Ark. App. 149, 152, 807 S.W.2d 39, 41 (1991); *Muradian v. Haley*, 12 Ark. App. 138, 140, 671 S.W.2d 210, 212 (1984). ■