



California Courts Restrict Late Fees When Borrowers Default

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In a case of first impression, California courts significantly restricted the late fees a lender can charge when a borrower defaults on a loan secured by real estate. The court held that certain late fees, which bear little or no relationship to the actual loss incurred by the lender due to the borrower's default, violate California Civil Code Section 1671 and become unenforceable penalties.

The ruling significantly impacts the revenue and rate of return on such loans, as well as the way they can be structured. This article lays out the history of the dispute, examines the court's application of the law in its ruling, and suggests next steps for lenders.

Offending Loan Agreement & Late Fees

In *Honchariw v. FJM Priv. Mortg. Fund, LLC*, [83 Cal.App.5th 893](#), 299 Cal. Rptr.3d 819 (App. 1st Dist. 2022), a husband and wife took out a \$5.6 million bridge loan at 8.5% interest from FJM Private Mortgage Fund, LLC, a private lender licensed under the California Financing Law.

The note was secured by a first lien deed of trust against their property.

The Honchariws were late in making a monthly installment payment on the loan. FJM Fund charged the Honchariws "late fees" as per the signed terms of the loan agreement as follows:

- A 10% late fee of \$3,967, assessed on the late installment payment of \$39,667,
- Default interest of 9.99% assessed against the entire unpaid principal balance of the loan, to be charged "automatically and without notice, from the time of default, until this Note has been paid in full, or until the specific default has been cured."

The late fees were essentially a liquidated damages provision.

Challenge to Late Fees

The Honchariws challenged the late fees and filed a claim for arbitration. They alleged that FJM Fund violated Business & Professions Code Sections 10240 et seq. by failing to make the necessary disclosures concerning the loan fees, charges, and costs, as required by the Truth in Lending Act; and the late fees were an unlawful penalty in violation of Civil Code Section 1671. The arbitrator disagreed and denied the Honchariws' arbitration claims.

The Honchariws sought to vacate the arbitrator's award before the superior court. They asserted the arbitrator had exceeded his powers because the award violated California public policy set out in Section 1671 pertaining to late fees. The superior court denied their claim, and the Honchariws subsequently appealed.

Liquidated Damages & Unlawful Penalties in California Contracts

California public policy requires liquidated damages to bear a "reasonable relationship" to the actual damages the parties would suffer from any future breach of the contract. *Garrett v. Coast & Southern Fed. Sav. & Loan Assn.*⁹ [Cal.3d 731](#), 108 Cal.Rptr. 845, 511 P.2d 1197 (1973). This means the liquidated damages must be based on "reasonable" efforts by the parties to calculate a "fair average compensation" for the loss they anticipate from a breach. Without such a relationship between the anticipated losses and the amounts demanded, the contract terms cease to be liquidated damages provisions and instead become penalties—which are unlawful.

Liquidated damages are "presumptively valid or invalid" depending on the subject matter of the contract. [Cal. Civ. Code § 1671](#). They are presumed invalid in consumer contracts that involve the "retail purchase, or rental ... of personal property or services, primarily for the party's personal, family, or household purposes." [Cal. Civ. Code §1671\(c\)](#).

In all other non-consumer (commercial) contracts, liquidated damages are presumptively valid unless a party “establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.” [Cal. Civ. Code § 1671\(b\)](#). Neither consumer nor non-consumer contracts may violate California public policy provisions.

An Unlawful Penalty

At the outset, the court determined the Honchariws’ loan agreement with FJM Fund was a non-consumer contract since it was not for the purchase of a primary residence or property for personal use. Hence, a liquidated damages provision in the loan agreement could be presumptively valid.

Additionally, the court reiterated that late fees are usually valid because they encourage borrowers to make payments on time and compensate the lender “for its administrative expenses and the cost of the money wrongfully withheld.” *Garrett*, supra, 9 Cal.3d at 739–740. However, if the primary purpose of the late fee is to compel timely payments by the “imposition of charges bearing little or no relationship to the amount of the actual loss incurred by the lender,” then they violate Section 1671 and become unenforceable penalties. *Garrett*, supra, 9 Cal.3d at 740.

Thus, late charges on the entire unpaid principal balance for failure to make an installment payment are punitive and not reasonably calculated to compensate the lender. A borrower cannot be forced to agree to a penalty in exchange for the right to be late on a payment.

Simply put, an amount that is not proportionate to the lender’s anticipated damages is a penalty. Contract language that permits such a penalty is void and exposes the lender to liability and legal action.

Significantly, here, the court noted that during the underlying arbitration, FJM Fund provided minimal testimony and evidence to support their position the late fees were tied to losses, costs, expenses, and/or damages actually incurred due to a single loan installment being late. In the arbitration, FJM Fund predominantly

relied on the terms of their loan agreement to justify the

Late Fees

The specific language of their loan agreement stated the late fee was being assessed because a default “will result in [FJM Fund] incurring additional expense in servicing the loan, including, but not limited to sending out notices of delinquency, computing interest, and segregating the delinquent sums from not delinquent sums on all accounting, loan and data processing records, in loss to [FJM Fund] of the use of the money due, and in frustration to [FJM Fund] in meeting its other financial commitments.” On this basis, and without any additional supporting testimony of its officers, financial calculations, or administrative documentation, FJM Fund asserted it would incur “difficult to estimate expenses as a result of the default.”

The court found this justification and explanation for the late fees, without more, to be insufficient. The court held the default interest of 9.99% charged on the entire unpaid principal balance if the borrower was late on even a single payment to be an unenforceable penalty.

Significantly, the court distinguished this case from situations where there was a default on a fully matured loan. In such instances, the court held that default penalty interest on the entire unpaid balance on a fully matured loan was still legal. *Thompson v. Gorner* [104 Cal. 168](#), 37 P. 900 (1894).

Next Steps

The court’s ruling significantly limits the revenue on loans secured by real estate. Further, it places an additional burden on lenders to carefully tailor their loan agreements and the late fee provisions imposed on borrowers, so the liquidated damages provisions more closely reflect the lender’s actual damages. It also increases a lender’s liability to its borrowers if the late fees charged are deemed to be not rationally related to the lender’s costs, expenses, and losses due to the late payments.

Additionally, the ruling arms borrowers with more rights to challenge the validity of the terms of a loan agreement, giving them additional avenues to contest the remedies available to lenders on loan defaults. As a result, lenders could see more lawsuits or class actions from borrowers on these issues.

Going forward, lenders must examine their late fee provisions to determine if they violate the ruling in this case, and may need to reexamine existing contracts to determine if amendments are needed to ensure compliance. Lenders that have other charges and payments based on late fees should take care to reevaluate these as well. Lenders must determine how their costs, expenses, and losses from a borrower's default can legally justify late fees they seek to charge. Financial calculations must be cross-referenced with the legal provisions to ensure lenders stay on the right side of the law.

Because loan agreements are voluminous and complex, and different lenders have different provisions and styles when preparing them, a case-by-case examination of documents would best prevent liability rather than a cookie-cutter solution.

For more information, please contact any attorney with Frost Brown Todd's [Business & Commercial Litigation](#) practice group.

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