Groundbreakers

by Joshua Stein

How Some "Standard" Language in a Promissory Note Cost a Lender Five Years of Default-Rate Interest

"Standard" language can produce unpleasant surprises when combined with nonstandard facts. A recent Ninth Circuit case, *In Re Crystal Properties, Ltd., L.P.,* 268 F.3d 743 (9th Cir. 2001) (affirming district court and bankruptcy court), demonstrates yet again exactly how this can happen.

The story begins with a typical acceleration clause. Here are the words of that clause, words that are familiar, perhaps even boringly routine, to any lending lawyer who has read more than a handful of promissory notes:

"Should default be made in any payment provided for in this note,…at the option of the holder hereof and without notice or demand, the entire balance of principal and accrued interest then remaining unpaid shall become immediately due and payable, and thereafter bear interest, until paid in full, at the increased rate of five percent (5%) per annum over and above the rate contracted for herein. No delay or omission on the part of the holder hereof in exercising any right hereunder,…shall operate as a waiver of such right or any other right under this note…."

The loan went into default. The lender notified the borrower that the loan was in default and that the default interest rate would apply (although some bills the lender sent provided erroneously for interest at the contract rate instead).

As so often happens under these circumstances, the lender seemed ambivalent about whether to enforce the loan documents vigorously or to try to work with the borrower to avoid a default. Ultimately, though, the borrower completely stopped paying. The lender pestered the borrower, and sent some bills for the full amount of the loan. At some point the borrower agreed to pay the full loan, less a discount, but the borrower never actually did so.

The maturity date came and went and the borrower still didn't pay. The borrower eventually filed bankruptcy. The lender asserted a claim in the bankruptcy, trying to collect (among other things) default-rate interest from the date the loan went into default. The lender's claim raised two issues:

- Could the lender collect default interest from and after the date of default?
- If not, could the lender at least collect default interest from and after the maturity date of the loan?

Before continuing, reread the quoted language from the promissory note and the summary of the facts, and then try to answer the two major questions the case posed, as summarized above. Do not proceed without doing that.

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Here is how the bankruptcy court, Federal district court, and Ninth Circuit all answered those two questions:

For the first question, the treatment of default interest after default, the courts held that under the default interest clause quoted above, the lender could not collect default interest until the lender actually accelerated the loan. But the lender never gave a notice that unambiguously accelerated the loan. Even though the borrower waived notice or demand as part of the quoted language from the promissory note, the lender still had to give notice of acceleration. Without such a notice, no acceleration could occur. Whatever communications the parties may have had, and whatever claims of default the lender may have made, they never amounted to an unambiguous acceleration of the loan. Without a valid acceleration, the lender could not collect default interest. A mere default was not enough to trigger default interest. So the lender lost. *Id.* at 749-53.

For the second question, the treatment of default interest after maturity, the courts held that under the language quoted above, only an acceleration of the loan could trigger default interest. The mere occurrence of the maturity date does not constitute an acceleration of the loan. To the contrary, once the maturity date occurs, there is nothing left to accelerate–the entire loan is already due and payable in full. And because the lender's right to collect default interest depends entirely on a valid acceleration (see the answer to the first question), the lender can never collect default interest if the maturity date occurs when the bank has not yet accelerated the loan. So the lender lost again. *Id.* at 753-55.

Based on these two answers to the two questions raised, the courts entirely disallowed the lender's claim for default-rate interest—even though the loan had been in default for several years. The precise words of the note as they governed acceleration and default-rate interest, when combined with the lender's apparent ambivalence about playing hardball, produced a result that this lender–and any lender–would regard as surprising. But this language was hardly weird or unusual. Very similar language appears in many promissory notes.

The case was decided in bankruptcy court applying California law. It is quite extensively reasoned, though, and the author does not object to that reasoning. The court faithfully interpreted the precise words of the document and applied them to the precise facts of the case. Any court in any state could easily reach the same result if given the same language and the same facts. One might argue that the court should have inferred that the parties intended the borrower to pay default-rate interest if the loan ever were in default. But that's not what the words of the note actually said.

For a lender and its counsel, and for anyone else writing legal documents, the *Crystal Properties* case teaches some important lessons, both about how to write legal documents and about how to enforce them.

The first drafting lesson, a small and specific one, relates to the calculation of default-rate interest. Loan documents should require the borrower to pay default interest starting from the date of any default, not when the borrower's cure period expires, or when the lender accelerates the loan, or when the lender gives the borrower notice of something, or when some other event occurs.

Default-rate interest should start to accrue at the earliest possible moment, i.e., the moment the borrower goes into default. That would include a default in making any regular payment, a default in repaying the loan on the maturity date, and any other form of default under the loan documents. That's what the loan documents should say. And they should not require the lender to give notice as a condition to collecting default interest.

Stepping back a bit from the narrow issue of default interest, the *Crystal Properties* case also demonstrates that whenever a document requires a party to do something, the drafter should focus on the "build-up" and context for that obligation (in this case, the obligation to pay default-rate interest).

Scrutinize the language that precedes or surrounds the obligation. Ask whether that language unintentionally sets conditions, limitations, and exclusions so an obligation might not arise under particular circumstances where it really should arise. Does the language narrow the scope of what should be a very broad obligation?

In the *Crystal Properties* case, the borrower's obligation to pay default-rate interest was inextricably bound up with, and part of, the clause that allowed the lender to accelerate the loan. Default-rate interest arose only after acceleration. From a lender's perspective, though, why should the two remedies be tied together in that way? A careful drafter might have realized instead that the obligation to pay default-rate interest should not be limited to the period after acceleration. Default-rate interest should not be held hostage to whether the lender has validly accelerated the loan.

Instead, default-rate interest should accrue under a broader set of circumstances, i.e., whenever an uncured default exists. From a lender's perspective, that's what the note should have provided. And if the note had so provided, would the borrower have objected when negotiating the loan documents? Probably not, or at least not successfully.

As another example of the same principle, consider some language in a lease the author recently handled. It said: "If Landlord consents to an assignment of this Lease and as a result of the use and occupancy of the Premises by the assignee, Operating Expenses are increased, then Tenant shall pay to Landlord, as Additional Rent, all resulting increases in Operating Expenses."

The quoted language–again, "standard" language—worked beautifully as long as every possible assignment of the lease always required the landlord's consent. The parties eventually agreed, though, that certain assignments would not require the landlord's consent. If the tenant made one of those "free" assignments, the condition set forth in the quoted language would not be satisfied, because the landlord had not consented to the assignment. If necessary, you could argue that the terms of the lease amounted to the landlord's consent to the particular assignment in question, but this may be a stretch. Therefore, even if the assignee's use and occupancy resulted in an increase in operating expenses, the landlord could not look to the assignee to pay it – because the landlord had never consented to the assignment. In this particular case, the result is not immediately horrible, of course, because the landlord would probably recover the extra costs through general escalations for operating expenses. But it was probably not the result the parties had in mind if they had actually thought about it.

Like the acceleration clause in the *Crystal Properties* case, the language in this lease produced an unexpected result, because in each case whoever wrote the language assumed that certain events would always occur together: an acceleration would always coincide with a default and the imposition of default interest, and an assignment of the lease would always coincide with the landlord's having consented to that assignment. In each case, though, that assumption turned out to be wrong. By tying the discussion to the particular assumption, the drafter unnecessarily narrowed the application of certain broad language that should, intuitively, have applied more generally.

Anyone writing a legal document should avoid making assumptions of this type. Don't unintentionally link a general concept to a more specific one in a way that might unintentionally narrow the application of the former.

As another view of the same drafting glitch, whenever a document says that a certain result follows when certain conditions have been satisfied, the drafter should ask whether the same result should also apply in other circumstances. If so, broaden the conditions that trigger the particular result.

The *Crystal Properties* case teaches yet another drafting lesson, one that may seem counterintuitive because it suggests that the drafter might have achieved more by seeking less. Remember that in the *Crystal Properties* acceleration clause, the borrower waived any right to notice or demand. That waiver language might have suggested to anyone reading the document that the lender could validly accelerate the loan and collect default interest merely by deciding to do so without telling anyone at all about the decision.

On the surface, such a suggestion may seem very lender-protective because, when the loan goes into default, this language maximizes the lender's flexibility, minimizes the lender's work, and might prevent errors. But it suggests the lender can follow a procedure that the *Crystal Properties* courts ultimately decided did not work, because a lender cannot accelerate without giving a notice of acceleration–with all the adverse implications for the lender discussed above.

If, on the other hand, the *Crystal Properties* note had expressly required notice of acceleration, such a requirement might (at least in theory) have helped the lender or its counsel remember to give such a notice when the need arose. In other words, an unenforceable waiver (in this case a notice waiver) may be worse than no waiver at all, because whoever must live with the document may believe that the waiver works and may proceed accordingly.

That person, the loan administrator, will probably be oblivious to legal principles that say that regardless of what the document says, a lender cannot accelerate without giving notice of acceleration. If the loan administrator is paying attention, or if the loan administrator's counsel reads the loan documents quickly without thinking through the issues, the two of them might assume that the loan documents mean what they say and the lender can accelerate the loan without telling anyone at all.

Under the facts of this case, the attorney who wrote the loan documents might have better served the lender by thinking of the loan documents as a "user's manual" for a legal relationship, telling the lender, its loan administrator and future counsel what they will need to do if they want to achieve a particular result based on particular facts. If the note had expressly required a notice to accelerate, or perhaps even just a notice to begin the accrual of default-rate interest, the lender or its counsel might (at least in theory) have recognized the need to give such a notice, and might actually have done so.

As a final drafting lesson, even if you prepare documents from "standard forms" that you have seen and used many times before, you should, at least in a perfect world, take the time to read through the documents to confirm that they work correctly under every possible, or at least likely, set of facts in your particular transaction. Even if the documents sound "standard," take the time to read them, think about them, and make sure they work.

Does that mean that when you prepare a set of loan documents you should read the "standard form" from beginning to end, looking for glitches, gaps, and possible problems based on every possible set of future facts reasonably imaginable? Will clients pay for that? Will transaction velocity allow it? Probably not.

Perhaps you should simply try to read through and think about some of the "hot button" provisions of the loan documents. Those would surely include the lender's most important rights and remedies after default, such as the rights to accelerate and to collect default-rate interest (which, as noted, should not necessarily be linked).

That last drafting lesson is also the first loan enforcement lesson. When a loan goes into default, begin by reading through the documents, and understanding exactly what they say. More specifically, think about exactly what rights and remedies you want to exercise. Then read the loan documents to understand, very specifically, exactly what the loan documents say you must do first if you want to exercise those remedies.

Under the words of the loan documents, what must happen before a lender can exercise particular remedies? And, beyond the terms of the loan documents, what else does governing law require a lender to do under the circumstances?

If the *Crystal Properties* lender and its counsel had performed such an analysis (and done so with 100 percent foresight about how the courts would apply the documents), they might have realized that the lender could not recover default interest unless it accelerated the loan and gave notice of acceleration. The *Crystal Properties* lender might then have tried harder to accelerate the loan in a way that raised no issues at all–which would, intuitively, have required a written notice for clarity.

As another loan enforcement lesson, a lender should seriously consider giving a formal notice of acceleration of any defaulted loan at the earliest possible opportunity. Such a notice will not only unambiguously satisfy the requirements of promissory notes like the one in *Crystal Properties*, but it will also satisfy legal requirements for a formal notice of acceleration and perhaps help convince the borrower that the lender is serious. Once the lender has validly accelerated, the rights and obligations of the parties change, and the lender usually gains leverage.

Even if the lender still hopes that the lender will be able to "work out" a reasonable resolution with the borrower, the lender should not let that ambivalence translate into an ambivalence in the actions it takes against the borrower. The lender can always rescind an acceleration and reinstate the loan if the parties make a deal. If the parties don't make a deal, the lender will have the benefit of an unambiguous written record that does not invite surprises of the type the lender experienced in *Crystal Properties*.