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SECURED TRANSACTIONS

'JCC Development v. Levy': Drafting Makes a Difference

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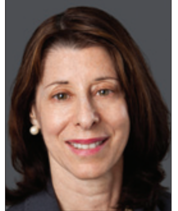

Attorneys who often draft or review loan documents become accustomed to standard language for certain provisions, and occasionally might not notice small variations which might contain a fatal flaw. We recently came upon a 2012 California state appellate court decision that illustrates this very well and provides a cautionary tale for lawyers.

The case of *JCC Development Corp. v. Levy*, 146 Cal. Rptr.3d 635 (2012) involved the provision in a promissory note that imposes default interest. Here, the court held that the lender could not collect interest at the default rate under the promissory note when the note matured, even though the borrower failed to pay principal and interest when due, because, in the court's view, the default interest provision was tied to acceleration of the debt. In simple terms, once the note matured the acceleration clause could not be triggered as there was nothing to accelerate.

Background

Default interest provisions, though they are certainly in every credit agreement, are rarely the subject of negotiations or legal disputes. Default interest is generally understood to be due when an amount is not timely paid, irrespective of whether that is at stated maturity, by acceleration, by mandatory prepayment or otherwise. Unfortunately the language in credit agreements or other debt instruments is not always this clear.

The genesis of the *JCC* case was a real estate transaction gone sour. The facts of that case were as follows: JCC Development Corp. (JCCDC), a non-profit public benefit corporation, owned and operated several Los Angeles-based community centers. It decided to sell one of those centers to raise cash and entered into discussions with Hyman Levy—a self-described philanthropist—sometime during the summer of 2005.

The parties agreed on a purchase price for the property of $2.7 million and that amount was placed into escrow by Levy as a show of good faith. Apparently, negotiations did not proceed quickly enough for JCCDC's cash needs. In September 2005 the parties agreed that the $2.7 million deposit would be converted to a one-year loan from Levy to JCCDC, to be paid on consummation of the sale. The loan was evidenced by a promissory note (drafted by Levy's counsel) and secured by a deed of trust on the proposed sale property. Under the promissory note, JCCDC agreed to pay Levy the principal sum of $2.7 million, "with interest from the date hereof, until paid, at the rate of five percent per annum, with the full

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amount of principal and accrued interest due and payable on or before September 30, 2006." No principal of the loan was payable prior to the note's maturity date.

The promissory note contained the following acceleration and default interest clause:

If: (i) Maker shall default in the payment of any interest, principal, or any other sums due hereunder, or (ii) Maker shall default on performance of any of the covenants, agreements, terms or provisions of the deed of trust securing this Note, or (iii) Maker shall sell, lease, convey, hypothecate, transfer, encumber or alienate the Property (defined below), or any part thereof, or any interest therein, or shall be divested of title or any interest therein in any manner or way, whether voluntarily or involuntarily, without the written consent of the Holder being first had and obtained; then, at Lender's option, all sums owing hereunder shall, at once, become immediately due and payable. *Thereafter*, interest shall accrue at the maximum legal rate permitted to be charged by nonexempt lenders under the usury laws of the State of California. [*Emphasis added*]

A year later, when the promissory note matured, the parties had still not come to agreement on the terms for the property sale. JCCDC did not repay the loan and Levy did not demand payment. Negotiations continued on and off until on or about April 2007, when they terminated.

During the summer of 2007 Levy made several demands for repayment of the loan. Each demand now included principal plus default interest after maturity at the per annum rate of 11.25 percent (the maximum legal rate).

While one can debate whether the language was truly unambiguous and whether extrinsic evidence of the parties' intent should have been allowed, the lesson of course for lenders is drafting, drafting, drafting.

JCCDC paid, under protest, the full amount Levy demanded under the note, including interest at the default rate, and subsequently sued Levy for overcharging JCCDC for interest and other amounts.

The Decision

In court, JCCDC argued, among other things, that Levy was not entitled to collect interest at the default rate after the maturity date because he had not exercised his option to declare the entire obligation due and payable, and that based on the language of the promissory note this action was required in order to claim default interest. The trial court rejected JCCDC's argument, ruling that the default interest rate was automatically triggered at the time the note matured, without a requirement that Levy notify JCCDC that he was exercising his option to cause all amounts to be due and payable and thereby "implement the default rate."

On appeal, JCCDC challenged, among other things, the trial court's ruling that the default rate was automatically triggered by JCCDC's failure to repay the loan on the stated maturity date. Levy argued that the default rate interest provision was separate and apart from the acceleration provision and not part of the acceleration clause. He further argued that an acceleration provision is generally meaningless in a single payment note.

The three-judge panel of the appellate court unanimously reversed the trial court's ruling.

The appellate court concluded that the default interest rate language was unambiguous, was part of the acceleration clause, and that the acceleration clause was not and could not have been triggered. It held that under the note's plain language once one of the circumstances occurred that would result in acceleration of the loan, "thereafter" interest could accrue at the maximum legal rate. It tossed aside Levy's argument that the default interest rate provision was separate from the

acceleration clause, finding instead that the default interest language appeared in the same paragraph as the acceleration clause, and there was no indication that this language related to circumstances other than acceleration.

The court also rejected as immaterial Levy's argument that the acceleration clause would be meaningless in a single-payment instrument, stating that whether or not the acceleration clause is meaningless, the default interest provision was simply part of that clause. However, the court pointed out that there were in fact other circumstances (*e.g.,* sale of the real property to a third party) that could trigger acceleration during the term of the note.

The court emphasized that, as drafter of the note, Levy could easily have included language making it clear that the default interest rate would apply not only after acceleration, but also after loan maturity. But he failed to do so.

Notably, in reaching its conclusion the court relied heavily on a 2001 9th Circuit Court decision (*In re Crystal Properties, Ltd., L.P.* 268 F.3d 743, 745 (9th Cir. 2001)) which involved a promissory note with very similar language. In that case, the promissory note stated "Should default be made in any payment provided for in this note,…at the option of the holder 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%) over and above the rate contracted for herein." The noteholder in that case unsuccessfully argued that the default interest provision was automatically triggered on maturity. Levy noted that, unlike the *JCC* case, the note in *Crystal Properties* was not a bullet payment note but instead required periodic installment payments of principal. However, the *JCC* appellate court was not sufficiently persuaded by this difference to distinguish that ruling.

Conclusion

The decision in the *JCC* case (and the *Crystal Properties* case as well) gave rise to a nonsensical result. It's difficult to blame the courts for that outcome. While one can debate whether the language was truly unambiguous and whether extrinsic evidence of the parties' intent should have been allowed, the lesson of course for lenders is drafting, drafting, drafting. Widespread market practice and pure economic logic and sense dictate that default interest is imposed when an amount due is not timely paid, whether after acceleration or otherwise. But the language in the promissory note in this case presented the courts with a significant obstacle in reaching that conclusion.

It is interesting to note that years after the *Crystal Properties* decision, loan documents even in the jurisdiction covered by that case continue to suffer from the same malady (at least from the lender's perspective). Lenders that expect (and all should) to charge default rate interest after maturity without additional notice should examine their loan documents to make sure they explicitly say this. Too often, these types of provisions are overlooked and the focus is on the terms that tend to be most heavily negotiated. The result can be a significant adverse monetary penalty for the lender in a default scenario.

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