INTEREST AND LATE CHARGES: HOW TO CHARGE CLIENTS

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Charging interest or late fees may improve collection of receivables but can also lead to discipline or statutory damages for the careless attorney.

Most lawyers have no desire to become bankers. And yet, particularly in tough economic times, lawyers and law firms find themselves acting as banks by unwillingly extending credit to clients who do not promptly pay their legal bills. The problem is compounded by the fact that most lawyers do not charge their clients any interest or late charges. As a result, the lawyer is often the last creditor to be paid.

An obvious possible solution to this problem is to begin charging interest or late charges. However, most lawyers and law firms have chosen not to take this route. First, the issue is divisive in many firms, pitting those lawyers who are most concerned about the financial problem of aging receivables against those who feel that charging interest to their clients would be unprofessional, distasteful, or otherwise objectionable. Second, lawyers are concerned that the practice of charging interest or late charges may violate the ethical rules, although the staff of the Lawyers Professional Responsibility Board regards the practice as permissible if the lawyer complies with all applicable laws and regulations.Ftn 1 Third, there are many federal and state laws and regulations governing transactions in which interest or late charges are imposed.

These laws and regulations, including the usury laws and the Truth in Lending Act and regulations, apply to lawyers and law firms as well as other creditors. Many lawyers find compliance with such laws and regulations to be either impractical or a major inconvenience. Regardless whether a lawyer has any expertise in banking, commercial or consumer law, courts expect lawyers to understand and comply with all applicable laws and regulations when charging interest or late charges. Lawyers who charge interest or late charges and do not comply with these laws and regulations may be subject to disciplinary action and substantial statutory damages.Ftn 2 The purpose of this article is to briefly explain the most important of these laws and regulations.

Interest and Usury

The Minnesota laws governing interest and usury are very complicated. However, it is possible to wander through the maze of laws and regulations by understanding a few basic rules.

First, a client is not obligated to pay interest to a lawyer before default unless the client agrees to do so.Ftn 3 A client's agreement to pay interest may be written, oral, or even implied. That is, a client's agreement to pay interest may be contained in a written agreement that is signed by the client, or the client may orally agree to pay interest without signing anything, or the client's agreement may be implied by the

client's conduct in continuing to deal with the lawyer after the lawyer informs the client that interest will be charged. However, an oral or implied agreement to pay interest in excess of 6 percent per year is not enforceable. To charge interest over 6 percent per year, the lawyer must have the client sign a written agreement, whether the client is an individual, a partnership, or a corporation.Ftn 4

It may be possible to charge a client interest after default without an agreement. That is, if the legal bill states that it is due and payable within 30 days, it may be possible for the lawyer to charge interest that does not begin to accrue until after the due date, even if the client does not agree in any way. However, there are two problems with this course of action. First, the staff of the Minnesota Lawyers Professional Responsibility Board frowns on the practice of charging interest or late charges without the client's agreement. A lawyer who does so could be subject to disciplinary action. Second, even if such interest were permissible, it would probably be limited to 6 percent per year.

Therefore, from a legal and ethical standpoint, a lawyer who wants to charge a reasonable rate of interest must have the client sign a written agreement. This in itself creates a real problem for many lawyers. It is very easy to insert an interest provision in an engagement letter or agreement. However, while some lawyers have successfully used engagement letters or agreements for years, many others did not begin to use them until they were recently pressured to do so by their malpractice insurance carriers. Also, very often engagement letters are not even signed by the client. Longstanding clients may not be willing to sign a letter or agreement when they previously have been dealing with the lawyer without such formalities. In other circumstances it may seem impractical or untimely to ask a client to sign an agreement. Despite all of these drawbacks, a lawyer who wants to charge interest should have the client sign a written agreement to pay interest.

Assuming that the client signs the agreement, what is the maximum interest rate that can be charged by the lawyer? A lawyer may use any of the following alternatives:

1. If the client is a corporation or a limited partnership, there is no interest rate limitation.Ftn 5 This alternative does not apply if the client is a general partnership or an individual.

2. If the principal amount of the indebtedness is $100,000 or more, or if there is a binding commitment to extend credit of $100,000 or more, there is no interest rate limitation.Ftn 6 This does not necessarily mean that a lawyer who expects the total bill to exceed $100,000 is not subject to any usury limitation. In fact, this alternative is most useful when the client already owes at least $100,000.

3. If the transaction is properly structured as a time price sale of legal services, it is not subject to the usury laws. This alternative applies the so-called time price doctrine, an often misunderstood creation of case law which cannot be found in the language of any applicable statute.Ftn 7 This doctrine has been used for decades by appliance dealers, home improvement contractors, and others who sell goods or services under retail installment contracts. Under the time price doctrine, a credit transaction is not usurious even though the time price differential (which is the difference between the cash price and the total amount to be paid over time) is greater than the maximum allowable interest under the usury laws. In order to properly structure the sale of legal services as a time price sale, the client should be given the choice between a cash price (payable in cash) and a time price (payable over time) before the legal services are provided. Also, except as required by the Truth in Lending Act and regulations, the agreement should not refer to principal, interest, or finance charges; and it should not provide for the accrual of the time price differential over time or the computation of the time price differential on the basis of any percentage of the lawyer's fees and

disbursements. The lawyer should carefully draft the time price contract and strictly comply with all case law requirements of the time price doctrine, since any departure may result in usury.Ftn 8 For example, it is not permissible to use the time price doctrine on a revolving charge account.Ftn 9 Furthermore, a relatively recent Minnesota Court of Appeals decision makes reliance upon the time price doctrine in any situation even more tenuous.Ftn 10 A lawyer should use a time price contract only when the total amount of fees and disbursements is set before any services are performed or any disbursements are incurred. Even then, reliance upon the time price doctrine as a method of avoiding interest rate limitations is not recommended.

4. Under the Minnesota open end credit law,Ftn 11 a lawyer may charge up to 1.5 percent per month (18 percent per year) if the client is an individual who uses the legal services primarily for personal, family, household, or agricultural purposes (not primarily for nonagricultural business purposes). This alternative is used by department stores and other sellers in connection with revolving charge accounts. Under this alternative, the client must enter into an agreement under which legal fees and disbursements may be charged to the account from time to time, the client may pay the balance in full or in installments, and interest is computed from time to time on the outstanding balance. If a finance charge is due, the lawyer may charge a minimum finance charge of 50 cents per month. The biggest problem with this alternative is that, except with respect to agricultural clients, the lawyer is required to provide the client with complicated open end credit disclosures from time to time. These are discussed in greater detail under "Truth in Lending," below.

5. If the client is not a corporation, and the amount of the client's obligation is less than $100,000, and the client's obligation is secured by a mortgage on residential real estate, the lawyer may charge up to 15.75 percent per year. This alternative is found in the statute commonly known as the Conventional Loan Act.Ftn 12 Under this statute, the lawyer must comply with additional requirements and restrictions. This alternative is most easily used when the client is signing a promissory note for legal fees and disbursements.

6. If the amount of the client's obligation is less than $100,000 and the client uses the legal services for business or agricultural purposes, the lawyer may charge up to 4.5 percent in excess of the discount rate on 90-day commercial paper at the Federal Reserve Bank of Minneapolis.Ftn 13 The discount rate varies from time to time. As of February 5, 1991, the discount rate was 6 percent per year, and the maximum interest rate under this alternative was 10.5 percent per year. Since there is no interest rate limitation if the client is a corporation or a limited partnership (under the first alternative above), this alternative is most useful for clients that are either individuals who use the legal services for business or agricultural purposes or general partnerships.

7. In other cases (where the client is an individual who uses the legal services for personal, family, or household purposes and not business or agricultural purposes, and the amount of the obligation is less than $100,000, and there is no time price contract or open end account, and the lawyer is not secured by a mortgage on residential real estate), the maximum interest rate is 8 percent per year.Ftn 14

Where the lawyer simply intends to have the client sign a written engagement letter which provides for services and interest over time, and the lawyer does not want to use the risky time price doctrine, and the client is not giving a mortgage on residential real estate, the foregoing rules can be summarized as follows. If the client is a corporation or a limited partnership, the lawyer may charge any interest rate stated in the agreement. If the client is a general partnership, or an individual who uses the legal services for business purposes, the maximum interest rate to be inserted in the agreement is 4.5 percent over the Federal Reserve

discount rate. If the client is an individual who uses the legal services for agricultural purposes, the maximum rate is either 18 percent per year under the open end credit law or 4.5 percent over the discount rate. If the client is an individual who uses the services for consumer (rather than business or agricultural) purposes, the most that can be charged is 18 percent per year under the open end credit law or 8 percent per year.

The statutory penalties for usury are severe. If a lawyer charges more than the maximum interest rate under the usury laws, the client has the following alternative remedies:

1. The client may recover from the lawyer the full amount of interest paid.Ftn 15

2. The lawyer may be prohibited from collecting both principal and interest, and may be required to refund all principal and interest paid.Ftn 16

3. If the principal amount is $100,000 or less and the client used the legal services for business or agricultural purposes, all unpaid interest may be forfeited and the client may be allowed to collect twice the amount of interest paid.Ftn 17

4. If the client is an individual who used the legal services primarily for consumer or agricultural purposes, and the interest is charged under an open end credit plan, the client may be allowed to recover three times any finance charge that is "imposed, charged or collected" as long as the violation continues.Ftn 18

These drastic remedies give the lawyer every incentive to comply with the usury laws.

Some Possible Exceptions

In several decisions, the Minnesota Court of Appeals has allowed creditors to recover interest in excess of 6 percent per year without a written agreement signed by the debtor.Ftn 19 Applying the so-called "doctrine of accounts stated," the court in those cases has allowed recovery of interest where the creditor sent the debtor a billing statement which provided for the interest charge and the debtor failed to object to the statement within a reasonable amount of time. These cases could lead one to the conclusion that a lawyer may charge interest by including it on the billing statement even if the client never signs a written agreement to pay interest. However, lawyers clearly should not rely upon these cases for the following reasons. First, the decisions contradict the Minnesota Supreme Court's ruling in *Wolpert v. Foster*Ftn 20 and the express language of the Minnesota usury statute,Ftn 21 both of which require a written agreement signed by the debtor, whenever the interest rate exceeds 6 percent per year.Ftn 22 Second, the staff of the Minnesota Lawyers Professional Board is not convinced that use of the doctrine of accounts stated is permissible. In view of these authorities and positions, the severe statutory penalties for usury, and the fact that, even under the accounts stated cases, the client can avoid the obligation to pay interest merely by objecting to the interest charge, a lawyer should not rely on the doctrine of accounts stated. A written agreement for interest, signed by the client, is recommended.

Another possibility is to use a late charge rather than interest. Some courts in jurisdictions other than Minnesota have characterized a late charge which reasonably approximates the damages that would be caused by late payment as liquidated damages (rather than interest) which do not cause the transaction to be usurious. Unfortunately, other courts have held that late charges constitute interest.Ftn 23 In Minnesota, there is no clear authority on the subject of late charges. In *First National Bank of Herman v.*

Cargill Elevator Co., the Minnesota Supreme Court did uphold a promissory note providing for a 5 percent collection fee in addition to interest at the maximum rate.Ftn 24 It should be noted that the promissory note which provided for the collection fee in that case was undoubtedly signed by the debtor.

Although the practice of charging a late fee involves some risk of usury if the principal amount is less than $100,000 and the client is not a corporation or a limited partnership, it may be possible for a lawyer in Minnesota to charge and collect a late charge in a specified amount or a specified percentage which does not accrue like interest over time.Ftn 25 If a lawyer decides to impose a late charge, it is prudent to include the late charge in a written agreement signed by the client.

As an alternative to charging interest or late charges, some lawyers have considered the possibility of offering discounts for cash payment or prompt payment. While these discounts are commonly used by nonlawyers to induce timely payment of trade receivables, there is no clear legal authority supporting their use in most situations. It could be argued that discounts are interest and are subject to the usury laws unless they clearly fit within any of the above-described statutory exceptions or judicial doctrines.Ftn 26 However, if a lawyer accepts payments by credit card, a discount for payment by cash, check, or other means not involving a credit card or an open end credit plan is not subject to state usury laws if the discount is offered to all prospective clients and the discount is clearly and conspicuously disclosed.Ftn 27

Truth in Lending

Apart from the laws on interest and usury, the truth in lending laws present the greatest challenge to lawyers who wish to charge interest or late charges to their clients. The federal Truth in Lending ActFtn 28 requires creditors to provide detailed credit disclosures to consumers in certain consumer credit transactions. The disclosure requirements are described in the Federal Reserve Board's Regulation Z.Ftn 29

To understand the truth in lending laws, the lawyer should keep three things in mind. First, generally speaking, Truth in Lending is only a disclosure law. Unlike the usury laws and various other substantive laws, Truth in Lending does not limit the interest rate or the other provisions of the agreement with the client. Second, the rules in the truth in lending laws are not necessarily consistent with the usury laws. Whatever constitutes interest under the usury laws may or may not constitute a "finance charge" for purposes of truth in lending. Each law has its own definitions and rules. Third, the requirements in the Truth in Lending Act and Regulation Z are very specific and technical. If Regulation Z requires a creditor to disclose a credit term in a certain manner, disclosure of the credit term in another manner is a violation.

The truth in lending laws do not apply to all clients. A lawyer is required to provide a client with truth in lending disclosures only if:

1. The client is a natural person; and

2. The client uses the legal services primarily for personal, family, or household purposes (not primarily for business or agricultural purposes); and

3. The lawyer allows the client to pay for the services over time; and

4. The principal amount is $25,000 or less, or the lawyer is secured by real estate or the client's principal dwelling (such as a mobile home); and

5. The lawyer charges a finance charge or there is a written agreement for payment in more than four

installments (not including a down-payment); and

6. The lawyer extends such consumer credit more than 25 times per calendar year (or more than five times per calendar year for credit secured by a dwelling).Ftn 30

To summarize these rules, a lawyer who regularly charges finance charges to individual clients (other than business clients and farmers) is most likely required to provide those clients with truth in lending disclosures. Therefore, in determining if a lawyer has to provide truth in lending disclosures, normally the crucial question is whether the lawyer is charging a finance charge.

The definition of "finance charge" for purposes of truth in lending is very broad. It includes interest, time price differential, and most discounts. However, if properly used, a late charge is not a finance charge under the Truth in Lending Act, and a lawyer who charges such a late charge (without also charging interest or some other finance charge) should not have to provide truth in lending disclosures.Ftn 31 To make sure that a late charge is not a finance charge for truth in lending purposes, the lawyer's agreement with the client should require the client to pay the bill by a certain date. Also, the lawyer should demand payment or take other action to collect if the client does not make payment by the due date. Fortunately, a late charge is not considered a finance charge, even if the lawyer continues to provide legal services to the client after default.Ftn 32

If the lawyer is required to give truth in lending disclosures to the client, the lawyer must first determine whether there is an open end or a closed end credit transaction. The reason is that the required disclosures for open end credit are completely different from the disclosures for closed end credit. If a lawyer provides a client with services over time and bills the client periodically with the addition of a finance charge, the lawyer is probably using an open end credit account and the open end credit disclosures may be required. An example of closed end credit is a nonrevolving promissory note signed by the client.

For open end credit transactions, the lawyer must provide the client with an initial disclosure statement before credit is extended, a periodic statement for each billing cycle until the obligation is paid in full, and other disclosures from time to time.Ftn 33 These disclosures, particularly the periodic statement disclosures that are typically given on a monthly basis, are detailed and somewhat complicated. The lawyer probably needs to have a computer software system that can generate the periodic statements accurately and in full compliance with Regulation Z.

For closed end credit transactions, the lawyer must provide the client with a disclosure statement before credit is extended. This statement is completely different from the initial disclosure statement for open end credit. The closed end credit disclosure statement contains specific disclosures that are segregated in a so-called "federal box."Ftn 34 The Federal Reserve has published model forms which can be used for this purpose.Ftn 35 Anyone using a model form should check the regulation to make sure that the form contains all required disclosures for the particular transaction.

If a lawyer is obtaining a mortgage or security interest in someone's principal dwelling, the lawyer also must provide copies of a notice of right to cancel and wait at least three business days before providing any services.Ftn 36 This requirement, which applies to both open end and closed end transactions, gives the debtor a cooling-off period to determine whether he or she really wants to place a lien on the residence to secure the creditor. The debtor may change his or her mind and cancel the lien during the three-day period.

A lawyer who fails to comply with these requirements (or other truth in lending requirements relating to credit card accounts, home equity lines of credit, and credit advertising) may be held liable for actual damages, automatic damages, costs, and attorneys fees and the client may be able to obtain an award without showing any damage. If a required notice of right to cancel was not provided, the court may cancel the mortgage or security interest.Ftn 37

Conclusion

Anyone who reads this article without some prior knowledge of consumer law might find all of these requirements to be somewhat overwhelming. In fact, this article is only a brief summary of the applicable laws and regulations, and many more pages could be written on this subject.Ftn 38 However, the uninitiated should keep one thing in mind. It is not impossible to comply with these laws and regulations. Many of our clients, such as banks and retailers, have been complying with these requirements for many years. The courts and the disciplinary authorities merely expect us to comply with the same laws and recommendations.

Risk of Noncompliance

Two leading Minnesota cases illustrate some of the risk lawyers face if they charge interest or late charges without scrupulously complying with applicable laws and regulations.

In *Katz & Lange, Ltd. v. Beugen,* 356 N.W.2d 733 (Minn. App. 1984), a law firm sent a client billing statements which provided for a service charge of 12 percent per annum. The client did not agree to pay the service charge. Even though the client never did pay any service charge, the Minnesota Court of Appeals held that the service charge was a violation of the Minnesota usury laws. The law firm was required to forfeit all of the service charges. The court could have ruled that the entire debt was void, in which case the client would not have had to pay the bills at all. But the court mercifully declined to do so, stating that such a remedy would be "too harsh under the circumstances."

Second, in *Dougherty v. Hoolihan, Neils, and Boland, Ltd.* 531 F. Supp. 717 (D. Minn. 1982), the Minnesota federal district court held that a law firm was liable for truth in lending violations. After performing legal services for two clients, the law firm had the clients sign a promissory note (with an interest rate of 8% per year) and a mortgage on their homestead. The court held that the note and mortgage gave rise to a consumer credit transaction and that the law firm violated the Truth in Lending Act and regulations by failing to provide the required disclosures and notices of the right to cancel the transaction. Even though the amount of the note was only #739.08, the law firm was held liable for a total of $4,129.93 in statutory damages, costs, and attorneys fees and the mortgage was cancelled. In refusing to reduce the award under the statute, the court said in part, "Defendant is a corporation made up of attorneys who should be familiar with the requirements of the Act."

Recommendations

1. Before charging interest or late charges, have the client sign a written agreement which provides for the interest or late charge.

2. Do not charge a usurious rate of interest.

3. Even if the client is a corporation or a limited partnership, do not charge an unreasonably high rate of interest.

4. Do not use late charges, discounts (unless clearly exempt under federal law), or time price contracts.

5. If you want to provide ongoing legal services and charge a reasonable rate of interest to individual clients who use the services primarily or agricultural purposes, set up an open end credit account under the Minnesota open end credit law.

6. If you want to provide ongoing legal services and charge a reasonable rate of interest to individual clients who use the services primarily for personal, family or household purposes, set up an open end credit account under the Minnesota open end credit law, give the client an initial disclosure statement which complies with truth in lending requirements, use a computer system that generates periodic statements in compliance with Regulation Z, and otherwise comply with the Truth in Lending Act and Regulation Z.

7. If you do not want to be concerned about compliance with usury laws and certain other laws and regulations, allow your clients to make payments by credit card and thereby transfer to the card issuer the burden of compliance.

8. Consider the possibility of only charging interest to corporate and limited partnership clients so that there is no maximum interest rate and you do not have to comply with Truth in Lending or other consumer laws and regulations.

9. Comply with all other applicable laws and regulations.

10. If you are not familiar with the above laws and regulations, seek competent legal advice.

NOTES

[1] *For a discussion of ethical considerations in charging interest or late charges, see Wernz, "Interest on Attorneys Fees,"* 46 Bench & Bar of Minnesota 9 (October, 1989), *p. 18.*

[2] See e.g., Katz & Lange, Ltd. v. Beugen, *356 N.W.2d 733 (Minn. App. 1984);* Dougherty v. Hoolihan, Neils and Boland, Ltd., *531 F.Supp. 717 (D. Minn. 1982).*

[3] Lund v. Larsen, *24 N.W.2d 827 (Minn. 1946).*

[4] *Minn. Stat. §334.01, subd. 1;* Wolpert v. Foster, *254 N.W.2d 348 (Minn. 1977).*

[5] *Minn. Stat. §334.021.*

[6] *Minn. Stat. §334.01, subd. 2.*

[7] See, e.g., Schauman v. Solmica Midwest, Inc., *168 N.W.2d 667 (Minn. 1969).*

[8] Rathbun v. W.T. Grant Co., *219 N.W.2d 641 (Minn. 1974).*

[9] State v. J.C. Penney Co., *179 N.W.2d 641 (Wisc. 1970).*

[10] See St. Paul Bank for Cooperatives v. Ohman, *402 N.W.2d 235 (Minn. App. 1987).*

[11] *Minn. Stat. §334.16.* See *12 C.F.R. §§226.2(k), 226.2(r) (1971).*

[12] *Minn. Stat. §47.20.*

[13] *Minn. Stat. §334.011.*

[14] *Minn. Stat. §334.01, subd. 1.*

[15] *Minn. Stat. §334.02.*

[16] *Minn. Stat. §334.03.*

[17] *Minn. Stat. §334.011, subd. 2.*

[18] *Minn. Stat. §334.18.*

[19] See e.g., American Druggists Insurance v. Thompson Lumber Co., *349 N.W.2d 569 (Minn. App. 1984);* Butler Mfg. Co. v. Miranowski, *390 N.W.2d 380 (Minn. App. 1986);* Walden Bros. Lumber, Inc. v. Wiggin, *408 N.W.2d 675 (Minn. App. 1987);* Lampert

Lumber Co. v. Ram Construction, *413 N.W.2d 878 (Minn. App. 1987).*

[20] *254 N.W.2d 348 (Minn. 1977).* See *supra at note 4.*

[21] *Minn. Stat. §334.01, subd. 1.*

[22] See also Katz & Lange, Ltd. v. Beugen, *supra note 2.*

[23] *See generally Annot., 63 A.L.R.3 rd 50 (1975); Karlin, "Interest on Legal Fees," 58 J. Kan. B.A. 23, 25 (1989); O'Malley, "Late-Payment Charges: Meeting the Requirements of Liquidated Damages," 27 Stan. L. Rev. 1133 (1975). See also Gorco Constr. Co. v. Stein, 99 N.W.2d 69 (Minn. 1959).*

[24] *192 N.W. 111 (Minn. 1923). See also Kroll v. Windsor, 107 N.W.2d 53 (Minn. 1960).*

[25] *But see Minn. Stat. §334.01, subd. 1, which could be construed to mean that late charges constitute interest on obligations of less than $100,000 which accrue interest before the due date.*

[26] *See, e.g., Ruminant Nitrogen Products v. Zittle, 78 App.Div.2d, 433 N.Y.S.2d 644 (1980); Backman, "Consumer Credit and the Learned Professions of Law and Medicine," 1976 B.Y.U.L. Rev. 783, 800-801.*

[27] *15 U.S.C. §§1666f(b), 1666j(c).*

[28] *15 U.S.C. §1601 et seq.*

[29] *12 C.F.R. Part 226.*

[30] *12 C.F.R. §§226.2, 226.3.*

[31] *12 C.F.R. §§226.4(b), 226.4(c)(2).*

[32] *Regulation Z Official Staff Commentary §226.4(c)(2).*

[33] *See 12 C.F.R. §226.5 et seq.*

[34] *See 12 C.F.R. §226.17 et seq.*

[35] *12 C.F.R. Part 226 Appendix H.*

[36] *12 C.F.R. §§226.15, 226.23.*

[37] *15 U.S.C. §§1635, 1640.*

[38] *Lawyers who extend credit to their clients (whether or not interest is charged) may be subject to many other federal and state laws and regulations, such as the Equal Credit Opportunity Act and Federal Reserve Board Regulation B, the Minnesota Plain Language Contract Act, the Minnesota Consumer Credit Sales Act, the Fair Credit Reporting Act, the Federal Trade Commission's Credit Practices Rule, and the Federal Trade Commission's Rule on Preservation of Consumers' Claims and Defenses.*