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By Stephen T. Whelan

In the Penalty Box: Default Interest

IT USED TO BE AXIOMATIC. The borrower and its lender would enter into a loan agreement or a finance lease, and agree that, upon an event of default or even a delinquent payment, interest would be charged on that payment (or upon the entire contract balance, if the event of default was followed by an acceleration of the contract balance) at a noticeably higher rate. The purpose of the enhanced interest rate was to motivate the obligor to pay on time and avoid any serious breach of its other obligations.

There were other reasons: An obligation that is in default requires additional attention by the lessor or lender, including internal workout staff and possibly in-house counsel. This involves extra expense, not always quantifiable like outside counsel fees. An enhanced interest rate is designed to compensate the lessor or lender for these unexpected costs.

Not anymore. A July 3, 2018, federal bankruptcy court decision, *in re: Altadena Lincoln Crossing LLC,* has declared that the increased rate of interest that the lender and the borrower had agreed to, both in the original loan agreement and subsequent forbearance documents, constituted an unenforceable penalty under California law. This article will discuss how lenders and finance lessors can cope with this judicial decision.

Default and Forbearance

The debtor approached East West Bank (EWB) in 2004 to provide construction loan financing for a mixed-use project in California. The loan bore a default rate of interest 5% above the base interest rate. The debtor failed to repay the loan at maturity and a succession of forbearance agreements ensued. In each forbearance agreement the debtor acknowledged the amounts due, including the accrued amount of default interest and a general waiver of claims against the bank related to the loans.

Perhaps intending to motivate the debtor to make payment eventually, the bank agreed that the debtor could pay interest at the nondefault rate during the forbearance period and that it would forgive all default interest if the debtor repaid the entire principal balance by the (new) maturity date provided in each forbearance agreement. The bank also agreed that its extension fee of $600,000 could be paid at maturity rather than at the time that it agreed to extend the maturity.[1]

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At the bankruptcy court hearings on the debtor's objection to EWB's claims, witnesses testified that an additional 5% interest rate during default "was common for these kinds of loans at the time the loans were made." Yet the court spotlighted loan agreement provisions "that require the Debtor to pay EWB's out-of-pocket costs for servicing or attempting to collect on the loan in the event of default" and then leaped to the conclusion that "the default interest rate was not intended to compensate EWB for any of these types of expenses." The court reached the same conclusion with respect to late fees for delinquent or missed payments.

Flawed Reasoning

The court may have had a point in these two conclusions, but the decision then ventured far afield. It discussed the bank's expert testimony that "one of the central purposes of default interest is to compensate the lender for the heightened risk that defaulted loans carry of non-payment of the loan's principal and interest." The decision then declared that there was no evidence that *at inception* the bank engaged in any analysis identifying how the default rate would compensate for its actual damages and concluded that the default interest rate did not bear a reasonable relation to the damages incurred by the bank and hence was "intended to serve as [an unenforceable] penalty." In effect the court declared that any post-default justification for the default rate would be invalid. On a technicality, the court also excluded testimony on "the impact of a loan's default on the reserves that the bank would be required to maintain."

The decision further aggravated this suspect conclusion by citing the bank's expert testimony that the default rate premium "can be utilized to offset [the] loss in value" of a defaulted loan, and then correctly postulating that that "this diminution in value would translate into a reduction in the price at which EWB would be able to sell the loan." But the decision observed—irrelevantly—that *EWB did not sell the loan* and hence the bank apparently never suffered this loss of value. But of course the bank did suffer a loss or it would not have needed to file a claim in the debtor's bankruptcy proceedings.

In effect, the court's reasoning would compel a lender to sell a defaulted loan, in order to establish its loss, rather than hold-

ing on and hoping that improved conditions would minimize any loss. Paradoxically, the court's doctrine likely would increase the amount of damage claims against the debtor, by encouraging premature sale of the loan, perhaps to a vulture fund which would pay less than fair market value.

The decision also airily observed that "the ease with which [the bank's expert] was able to perform the calculations" which he offered at the 2018 hearing showed that this calculation "would not be costly or difficult to estimate *at the inception of a loan.*" Seriously? A lender in 2004 should be able to estimate, accurately, what its loss (on a one-year loan) likely would be when its patience ended and demand was made for payment 12 years later?

UCC 2A to the Rescue?

The *Altadena* decision was grounded on California Civil Code section 1671(b), which provides that "a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."

In a true lease governed by Uniform Commercial Code Article 2A, however, the standard under section 2A504(1) differs somewhat: "Damages…may be liquidated in the lease agreement but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused by the default." The Official Comment to section 2A-504 observes that "The ability to liquidate damages is critical to modern leasing practice; given the parties' freedom to contract at common law," the drafters of Article 2A left the parties free to negotiate a formula as long as it is reasonable. Article 2A did not apply to the *Altadena* situation, but may help lessors to reach a different result.

What Else Can You Do?

Lenders and lessors can protect themselves further by 1) not selecting California as the governing law; 2) periodically calculating what its actual damages could be for loans of a certain type and establishing the default rate accordingly for each type of newly organized loan; 3) arguing that a default rate is not a liquidated damages provision but instead is compensation for increased loan loss reserves; and 4) distinguishing their state law from the text of the California statute. There is no surefire remedy, but there are steps that you can take to avoid the default rate penalty box. ☰

[1] "The Court finds that this fee was intended to compensate EWB for the administrative costs associated with entering into the Forbearance Agreements and that it is enforceable."

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