IF YOU CHARGE DEFAULT INTEREST, YOU'LL WANT TO READ THIS!

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Default interest is intended to compensate a lender for the additional cost and delay resulting from a borrower's default on the loan. Default Interest Rate provisions come in all sizes and are found in many different types mortgage loans. While these provisions are not prohibited, courts often view them with a suspicious eye. As discussed in this article, Bankruptcy courts in particular, do not like Default Interest Rate provisions. Fortunately, this one has a happy ending.

On March 6, 2019, in *East West Bank v. Altadena Lincoln Crossing, LLC* (C.D. Cal., Mar. 6, 2019, No. 2:17-BK-14276-BB) 2019 WL 1057044, the United States District Court for the Central District of California reversed the Bankruptcy Court, holding that California's liquidated damages statute does not apply to, or invalidate, a lender's Default Interest Rate ("DIR") provision. The Court then upheld the DIR provision, finding that there was a reasonable relationship between the default interest charged and the anticipated damages to the lender caused by the default. While this is a very positive result for California lenders, the decision is on further appeal. So stay tuned!

By way of background, in 2005, Altadena Lincoln Crossing, LLC ("Altadena") obtained a loan from East West Bank ("EWB") to finance a construction project, repayment of which was secured by a deed of trust on the property. The heavily negotiated loan agreement contained an industry standard generic provision increasing the annual interest rate by 5% in the event of Altadena's default. While the loan agreement was heavily negotiated, the DIR provision was not discussed. Ultimately, Altadena failed to repay the loan upon maturity in 2009, triggering the DIR provision. After eight years and thirteen forbearance agreements, EWB commenced foreclosure proceedings, resulting in Altadena filing for Bankruptcy.

In its objections to EWB's proof of claim for its loan, Altadena argued that the DIR provision constituted an unreasonable and unenforceable penalty under California's liquidated damages statute found in California *Civil Code* § 1671(b). *Civil Code* § 1671(b) 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."

The Bankruptcy Court ruled that the DIR provision was unreasonable and, as a result, was an unenforceable penalty under § 1671(b). The Bankruptcy Court noted that a liquidated damages clause is considered unreasonable if the clause bears no reasonable relationship to the actual damages which the parties could have anticipated would result from a breach at the time the contract was made. Additionally, the amount of liquidated damages must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained. Here, because EWB used an industry standard and generic DIR provision and did not even discuss the provision during negotiations, the Bankruptcy court concluded that the DIR provision was not included in the loan agreement pursuant to "reasonable endeavor" by the parties to estimate the actual damages EWB would suffer as a result of Altadena's default.

EWB wisely chose to bypass the Bankruptcy Appellate Panel ("BAP") and, instead, appealed the decision to the Federal Court's Central District. On appeal, the Central District Court overturned the prior decision, holding that not only is § 1671(b) inapplicable, even if it was, its application would not invalidate EWB's DIR provision.

Relying on California Supreme Court precedent dating back to the 1894 case entitled *Thompson v. Gorner* (1894) 104 Cal. 168, which held that a lender was entitled to charge the higher post-default interest rate that the parties had agreed upon at the time of the origination of the loan, the Court agreed with EWB's position that a prospective increase in interest rate of a fully matured loan upon default is not subject to a § 1671(b) analysis. Additionally, the Court refused to view the DIR provision as a penalty and instead likened the provision to an additional contract or agreement for an alternative performance (pay a higher interest rate upon default) in the event that the original anticipated performance (repay the full loan amount upon maturity) does not occur. Specifically, the Court stated:

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> This case is similar to *Thompson* in all material respects. In each case, at issue was a loan where the borrower had paid the interest due monthly, but when the loan matured and the principal was due, the borrower did not satisfy the full obligation under the note. In both cases, pursuant to the loan agreement, the interest rate increased upon the failure to pay the principal amount when due. These are the materials facts upon which the California Supreme Court found no unenforceable penalty and instead found that the agreement provided for an alternative performance that was not subject to the § 1671(b) analysis.

Moreover, the Court found that "[i]n *Thompson*, higher interest was assessed ... only on the amounts in default," and therefore, because Altadena, like the borrower in *Thompson*, defaulted on a fully matured obligation, the higher interest rate was assessed only on the defaulted amount, making the present case indistinguishable from *Thompson*. As such, the Court concluded that § 1671(b) was not applicable to the default interest rate provision at issue in on appeal.

Notwithstanding the fact that § 1671(b) was found to be inapplicable, the Court also took issue with the Bankruptcy Court's legal conclusions with respect to its application of § 1671(b) to the DIR provision in question. Notably, the Court pointed out that the Bankruptcy Court misinterpreted the "reasonable endeavor" language as a requirement that the DIR provision actually be subject to negotiation by the parties prior to contract formation. This misinterpretation ultimately led to Bankruptcy Court's improper conclusion that the industry standard and generic DIR provision was unenforceable because the parties never engaged in any negation regarding its inclusion in the loan agreement. The Court expressly held that:

> There is no requirement that the parties negotiate a liquidated damages provision for it to be enforceable; instead, the "reasonable endeavor" requirement means only that a liquidated damages provision must be reasonable in light of the potential harm that could result from a breach, as that harm could be anticipated at the time of contract formation.

After finding that § 1671(b) did not apply, the Court focused its analysis on whether Altadena met its burden of establishing that the 5% DIR increase was not, at the time of contract formation, a reasonable estimate of the potential harm to EWB if Altadena defaulted.

In concluding that Altadena failed to meet its burden, the court looked to the expert testimony provided by the parties. The Court was ultimately convinced by EWB's uncontradicted expert testimony that detailed how a borrower's default reduces the value of the lending bank's asset (i.e., the "loan") in a measurable economic way. The expert testimony led the Court to conclude that the diminution in value of the loan as an asset held by EWB was within the range of actual damages that the parties could have anticipated would flow from a breach and that such increase in the interest rate upon default is a common method of recouping the type of loss incurred by a lender upon a borrower's default.

The Bankruptcy Court's Order may have initially felt like a blow to lenders throughout California, however, thanks to the Court's opinion on appeal, those feelings were short lived. However, before running out to include DIR provisions in every loan, please keep in mind that (1) the DIR must be a "reasonable estimate" of the potential harm to the lender caused by the default; and (2) Altadena has appealed the decision to the 9th Circuit Court of Appeals. Stay tuned for more once the 9th Circuit rules.

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