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Secured Lenders Alert: Judge Renders Default Rate Interest Uncollectable

The issue of whether default rate interest ("DRI") is an undue penalty imposed on a defaulted borrower is one that has challenged secured lenders in court proceedings for some time. This issue took center stage last July in the ongoing California bankruptcy case of Altadena Lincoln Crossing, LLC. Dealing a blow to secured lenders, The Honorable Sheri Bluebond, Chief Judge of the U.S. Bankruptcy Court in the Central District of California, ruled that DRI is an unenforceable penalty in a case where the lender fully recovers principal, interest and other costs of collection as set forth in the loan agreement.

This decision has secured lenders scratching their heads asking, among other things, two questions: (1) is the DRI provision in my loan documents void in bankruptcy or cases involving civil litigation when I fully collect principal, interest and costs of collection, and (2) should I change my loan pricing, my underwriting standards, and the way I track my costs of collection to justify that there are, in fact, extraordinary costs to manage "special assets." This article will address these questions and examine the issues behind the Judge Bluebond's decision.

The Case

On April 28, 2005 an $18 million construction loan was made to finance land and the construction of a Southern California mixed-use property. The 18 month loan was followed by a second $2.5 million loan required to complete construction; both loans matured in 2008 as real estate markets soured and the systemic crash of the U.S. financial markets accelerated. Faced with leasing challenges and a non-existent financing market, 13 forbearance agreements followed, the final of which extended the loan to April 15, 2016. During the forbearance process, the borrower was charged "exit fees" while continuing to acknowledge that it was obligated to ultimately pay accrued DRI. A portion of the collateral was sold in January 2015, reducing the loan balances to a total of $14 million.

In April 2017, the loan balance stood at $13.5 million while accrued DRI stood at $10.2 million, ballooning total secured debt to $23.7 million. Unable to refinance the secured lender's loans, the borrower sought Chapter 11 bankruptcy protection to avoid foreclosure and restructure many classes of debts. An obvious impediment to reorganization was the level of DRI which if paid, would wipe out many classes of subordinate creditors. The borrower pled that the accrued DRI bore no correlation to actual damages suffered by the secured lender, and sought elimination of the DRI. Sensitive to cries from unsecured creditors the Judge asked for testimony.

The Testifying Experts

Critical to presenting its case in court, the borrower engaged a seasoned expert witness to present why the level of DRI was unconscionable, how its imposition made reorganization impossible, and why DRI should be viewed as a penalty considering the "exit fees" charged by the lender during successive forbearance periods. Among other things, borrower's expert concluded that (i) the 5% DRI was not proportionate to the lender's anticipated damages and costs, (ii) loan terms for both DRI and late charges were not negotiated at loan origination, (iii) the lender never attempted to approximate the costs of collection when the loan was originated, (iv) the DRI terms in the loan were arbitrarily set according to industry standards, and (v) multiple terms in the loan agreement already permitted the lender to collect costs and/or expenses should the loan default. Simply put, the expert concluded that the DRI is penal in nature.

In opposition to borrower's expert, the lender presented two rebuttal experts – the first an experienced construction lender, but with no previous testifying experience. This expert explained that when a loan is underwritten, it is impossible to anticipate if and when a loan will default, and if it does, one cannot estimate the amount of damages the lender will incur during the collection process. Consequently, an industry standard default rate of 4% to 5% over the note rate is customarily accepted by borrowers. The second expert was an academic professor who offered testimony that DRI only partially compensates the lender for risk of loss. He cited that at the point of default the value of the loan declines and the risk of loss is heightened. Studiously, statistics were presented showing that over 50% of defaulted mortgages end up in foreclosure, and that the collateral for those foreclosures is typically liquidated at historic recovery rates of 67% to 69% of principal balance. Through quantitative analysis, the expert justified the DRI as being fair and appropriate, especially considering the protracted forbearance period and poor underlying market conditions that were present in this situation. This professional had not testified as an expert during the four-year period previous to his report.

Notably, neither of lender's experts had deep experience collecting upon defaulted commercial real estate mortgages, nor did they have hands-on extensive experience in problem loan asset management for financial institutions or special servicers for commercial mortgage-backed securities.

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The Judge's Ruling

In addition to reviewing the expert reports, the Judge entertained live testimony from each expert. After consideration, the Judge ruled that the DRI sought by the lender constituted an unenforceable penalty that cannot be collected pursuant to California Civil Code 1671 (b). Additionally, the lender's claim for legal costs, expert witness fees, and other costs to pursue its DRI claim were disallowed. Judge Bluebond supported her decision citing the following:

(i) None of the fact witnesses could remember any negotiations at the point of loan origination or for the forbearances to show how the default rate of interest was set;

(ii) One of the lender's experts testified that borrowers do not generally shop for loans based on what the default rate might be;

(iii) The "exit fees" payable during the forbearance periods were appropriate compensation for the lender;

(iv) The lender was already being paid its out-of-pocket costs of collection as called for in the loan agreement including legal fees; costs to insure, maintain and preserve the property; title reports; appraisals; environmental updates; court costs and filing fees. DRI is not intended to compensate the lender for these types of expenses;

(v) Neither side presented any documents, testimony or other evidence of any kind to suggest that the choice of a 5% DRI resulted from any effort on the part of the lender or anyone else to quantify, estimate, or approximate any damages that might be expected to flow from the borrower's default;

(vi) It was the lender's practice during the relevant time period for the lender to use a 5% DRI whenever it made a construction loan;

(vii) The "exit fees" were included at the point of forbearance and intended to compensate the lender for the administrative costs attendant to the several forbearances and are permitted;

(viii) Late fees are intended to compensate the lender for any administrative costs of processing and servicing late payments; and

(ix) It would not have been costly or inconvenient at loan origination for the lender to make a calculation of administrative costs associated with overseeing and servicing a defaulted loan. The lender could have tracked and documented these costs when the default did occur, and could have included a provision in the loan agreement passing these distinct costs to the borrower as they accrued.

Where Does This Leave Secured Lenders?

Present market conditions should give most lenders comfort. According to the Green Street Commercial Property Price Index, property prices are 32% higher than the 2007 price peak, a condition that allowed for a very soft landing from the 2016-2017 "wall of maturities." On the other hand, for properties that have lost major tenants or had their rent rolls ravaged by new competitive construction projects, problems exist. Yes, there are foreclosures and properties are being surrendered to lenders today. In cases like Altadena, bankruptcy is filed despite "springing guarantees" in an effort to restructure.

Looking back 25 years at the origination practices of CMBS lenders, and even farther back at the way banks originated construction and permanent commercial real estate loans, one should acknowledge the validity of certain rulings made by Judge Bluebond. In a survey I conducted of 15 lenders, standard default rates that were charged fell in a narrow range of 4% to 5% over the note rate, yet few would acknowledge that this rate was vigorously negotiated. Lenders also acknowledge that during the origination process, they do not routinely attempt to estimate the cost of running a special assets department in concert with setting the default interest rate. If this survey holds true among the majority of commercial real estate lenders, lenders can expect DRI claims to be challenged in both civil and bankruptcy courts.

To Combat These Courtroom Actions a Few Recommendations Include the Following:

(i) Engage a testifying expert to conduct a quantitative analysis of the special servicing fee, restructuring fee and resolution fee charged to show exactly how much it costs to manage a defaulted loan;

(ii) Engage an expert who has run a troubled loan management or special servicing company who can explain what his or her company would independently charge to evaluate, manage and dispose of a troubled loan portfolio on a contract basis;

(iii) Make sure that forbearance agreements specifically state that default rate interest is additional consideration for the forbearance;

(iv) Track the man hours associated with managing a defaulted loan from the hand-on asset management level to credit committee members; add in an overhead allocation based upon the size of the managed portfolio and the size of the subject loan;

(v) Consider increasing loan extension fees as these type of fees were justified according to the Judge Bluebond ruling; and

(vi) At loan origination, the DRI provision should be discussed in detail. In hand, the lender should present a brief model showing how the loan size, terms and conditions would change under an internally prepared "stress test." By stressing the underwritten net operating income by 15% and 30%, the lender can show how the loan balance would decrease and/or the interest rate increase, followed by a discussion of why the DRI provision is justified. The borrower should sign-off of on the calculations and acknowledge the discussion.

Is There Hope for Default Rate Interest?

Litigation surrounding this issue will likely increase in 2019 as the borrowing community and their lawyers learn about Judge Bluebond's decision. However, there is positive light on the subject as a result of the November New Jersey Appellate Court decision in the Case of GECMC 2006-C1 Complex 400, LLC. In that case the appellate panel upheld the lender's right to collect DRI. They found that the default rate of 5% was neither punitive nor unreasonable, and was negotiated between sophisticated commercial parties, who were represented by counsel.

Needless to say, there is more to come on this issue. Documentation is key, and finding experienced lawyers and experts to defend DRI claims, and justify payments due the lender will go a long way toward covering the lender's cost to evaluate, manage and dispose of troubled commercial real estate loans.

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