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Commercial Lending Update

APRIL 2019

THE END IS NEAR FOR LIBOR

The London Inter-Bank Offered Rate (LIBOR) will not be calculated after December 2021. Financial institutions need to prepare for LIBOR's end and the transition to a replacement index. Numerous loans and financial contracts use the LIBOR interest-rate index, including consumer and commercial mortgages, derivatives, interest rate swaps, SBA 7(a) loans and corporate funding instruments. Some of these contracts may mature after December 2021, so financial institutions need to start planning for the transition and for future transactions.

In 2017, the Federal Reserve Board and the Federal Reserve Bank of New York (in cooperation with the Department of the Treasury and the Commodity Futures Trading Commission) formed the Alternative Reference Rates Committee (ARRC) to identify a replacement rate for LIBOR and adopt a plan to facilitate the transition from LIBOR. ARRC chose the Secured Overnight Financing Rate (SOFR) which is based on the overnight U.S. Treasury repo market.

For existing loans and financial contracts, ARRC suggests that institutions identify their current portfolio of LIBOR-based loans and other instruments, and pinpoint which ones will or may mature after LIBOR's end in December 2021. Fallback contract language needs to be drafted (and agreed to by all parties) to address how interest will be calculated once LIBOR is gone.

Guiding principles for fallback contract language appear on ARRC's website at **www.newyorkfed.org/arrc/fallbacks-contract-language**. For new loans or financial contracts that are expected to mature after December 2021, LIBOR should not be chosen as the sole index. Transition verbiage to a replacement index should be built into the contract from the start.

Last month, the FDIC included an article examining the future of, and alternatives to, LIBOR in its Winter 2018 issue of "Supervisory Insights." The FDIC is an ex officio member of ARRC but does not endorse or require its supervised institutions to use any particular reference rate to replace LIBOR. Rather, the FDIC believes that the use of a particular reference rate is a business decision for each institution to make based on its needs and unique circumstances.

According to the FDIC, SOFR is a transaction-based rate incorporating tri-party repo data, the Fixed Income Clearing Corporation's (FICC) General Collateral Finance Repo data, and bilateral Treasury repo transactions cleared through the FICC. The FDIC said that SOFR is quite different from LIBOR as it is based on actual overnight secured transactions that could vary significantly from LIBOR under some market conditions.

In its Winter 2018 publication, the FDIC identified another U.S.-based alternative reference rate the American Financial Exchange (AFX) created. AFX's alternative rate is Ameribor which reflects the

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borrowing costs of more than 100 U.S. small and mid-sized banks using a 30-day rolling average of the weighted average daily volume in the AFX overnight unsecured market.

The FDIC advised that ARRC is also working on a term rate and that AFX may create other reference rates.

Drafting these index rate provisions may not be as easy as it sounds. Some parties think SOFR is more volatile than LIBOR and desire additional protective language in the contract. Ameribor is also an unknown and untested index rate. For additional assistance, contact Mark Aldrich at **MAldrich@ABLawyers.com** or Robert Olsen at **ROlsen@ABLawyers.com**.

L.A. Federal Court Upholds Default Rate on Commercial Construction Loan

A Los Angeles federal court recently upheld the validity of a default interest rate on a large commercial construction loan, rejecting the borrower's assertions that the default rate was an improper form of liquidated damages. The United States District Court for the Central District of California reversed the bankruptcy court's order and held that a default interest rate provision allowing for a five percentage point increase on a fully matured commercial loan is enforceable under California law. *East West Bank v. Altadena Lincoln Crossing, LLC*, 2019 U.S. Dist. LEXIS 36200 (C.D. Cal. Mar. 6, 2019).

In this case, the borrower took out two separate construction loans totaling $28.5 million but was unable to repay them upon maturity, which triggered a default interest rate provision. Subsequently, East West Bank and the borrower entered into a series of forbearance agreements over the course of eight years. These agreements maintained the default interest rate and reflected the amounts then due, including the then-accrued default interest. After East West Bank refused to renew the last forbearance agreement, the borrower filed for bankruptcy and objected to the bank's claims for default interest. The bankruptcy court found that since the default interest rate was an industry standard, it did not reasonably estimate a fair average compensation for possible loss and was thus invalid as a form of liquidated damages. East West Bank appealed.

In analyzing the default interest rate provision's validity, the district court first looked to California precedent and held that the provision was not liquidated damages but rather "alternative performance." Alternatively, the court analyzed the default rate under Cal. Civ. Code Section 1671(b) which provides a presumption of validity for liquidated damages provisions in commercial transactions. According to the court, even if Section 1671(b) applied, the borrower did not meet its burden to rebut the presumption since it could not demonstrate that at the time of contract formation, the increase did not represent a reasonable estimate of the potential harm to East West Bank upon default. The court noted that the bank's imposition of additional fees upon default did not make the added interest a penalty. The court also relied on the testimony of the bank's expert as to the diminution in the loan's value due to the borrower's default, which the court said qualified as anticipated actual damages.

There are a couple of nuanced points in this case that are worth noting. First, the court's decision provides hope for creditors that bankruptcy claims for default interest will not be diminished prior to approval of a plan or reorganization. Additionally, the default interest amounted to over $10 million, almost the amount of the outstanding principal balance on one loan, which was only $13 million. The court upheld this amount that accrued over nine years despite the claims made by the borrower's expert witness that the interest amount was "shocking" and "staggering."

While this result seems like a win for creditors, it is not a bad idea for creditors to be wary about its broader application. For one thing, the borrower had legal representation during the many forbearance negotiations, noted by the court in support of its conclusion that the default rate was reasonable. Whether a similar result awaits an unrepresented borrower remains to be seen. Finally, as of this writing the plaintiff had not appealed the district court's decision. And, while the holding of the district court is persuasive, it remains to be seen whether other courts will follow suit.