

Chapman Sidebar

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I'm a Secured Creditor so I'm Entitled to Default Interest, *Right?*

As prices for distressed loans have risen, holders of secured claims are focusing not only on the recovery of principal but also on repayment of interest, fees and pre-payment-premiums or "make whole" payments. As we discussed in our prior client alert entitled [Make-Whole Provisions Continue to Cause Controversy: What You Can Do to Avoid Litigation](#), whether or not a secured creditor is entitled to a make-whole premium is primarily dependent on the contractual language in the credit agreement or indenture and the facts surrounding the repayment of the debt obligations. Similarly, whether or not secured creditors are entitled to claim default interest will depend on several factors, including the language in the loan agreement, the value of the collateral securing the loan, the nature of the default triggering the right to default interest and the equities of the case. This alert discusses the primary questions secured creditors should ask in determining whether their claim for default interest is likely to be allowed.

Am I Entitled to Default Rate Interest Accrued Prior to the Bankruptcy Filing?

In analyzing any claim for default interest, the first determination should be whether the interest at issue was incurred prior to, or following, a bankruptcy filing. This is important as courts consistently allow pre-petition default interest at the rate provided for in the underlying agreement as part of a secured claim.¹ Further, unlike claims for post-petition default interest, there is no "equitable" test with respect to pre-petition default rate interest.² Even if the court believes that the default rate is high, it typically will not alter the unambiguous terms of an agreement that was negotiated by sophisticated parties at arm's length unless there is clear evidence of overreaching by the lender.³

Am I Entitled to Default Rate Interest Accruing After a Bankruptcy Filing?

Before analyzing secured creditors' rights to claim default rate interest following a debtor's commencement of a bankruptcy proceeding, it is important to understand the general rule regarding the accrual of non-default rate interest following a bankruptcy filing. Generally, secured creditors are entitled to accrue post-petition interest in two instances: (i) to the extent the secured creditor is oversecured (*i.e.*, creditor's claims are secured by collateral having a value exceeding the amount of the claim)⁴ and (ii) when the claim is asserted against a solvent debtor.

To the extent a secured creditor satisfies one or both of these requirements, in determining whether a secured creditor is

entitled to a default rate of interest, bankruptcy courts have required a further "equitable" review to determine whether: (i) there has been creditor misconduct; (ii) application of the default interest rate would harm unsecured creditors; (iii) the default interest rate constitutes a penalty; or (iv) application of the default interest rate would impair the debtor's "fresh start."⁵ When these factors are absent, courts are reluctant to modify private contractual agreements concerning post-petition default interest rates and will typically allow the claim.⁶

Whether a claim for default interest will be disallowed upon equitable grounds will largely depend on the facts of the specific case. For example, courts will not likely find evidence of misconduct simply because a creditor has asserted its rights or raised objections to a debtor's motions.⁷ Courts will also typically not find default interest to harm unsecured creditors where the debtor is solvent and all creditors are being paid in full.⁸ If a debtor is liquidating, courts may not find that payment of default interest would interfere with a debtor's "fresh start."⁹

Although courts typically will not find default interest to be an impermissible penalty when it is included in a credit agreement that has been negotiated at arm's length by sophisticated parties, at least one court has held that the default rate was an unenforceable penalty where the loan agreement provided for a 25% default interest rate, finding that its application would be inequitable as the spread between the non-default and default rates was "significant and unexplained," the enforcement of the default rate would adversely affect creditors of the insolvent estate and, because the debtor cured the default under its plan, all of the consequences of the default were eliminated.¹⁰

In addition, where payment of default interest would result in a sizeable reduction in distributions to unsecured creditors, or possibly prevent the debtor from confirming a plan, courts have denied such claims upon equitable grounds.¹¹ However, in an important recent decision arising from the *Residential Capital* case, the bankruptcy court in the Southern District of New York held that even though the debtor was insolvent and unsecured creditors' recovery would be reduced, the payment of \$5 million in default rate interest to an oversecured creditor was allowed, finding that allowing such claim would only diminish the pool of distributable assets to unsecured creditors by 0.2%, and that the financing provided by the lender had greatly assisted the debtors, resulting in a benefit to the unsecured creditors. While largely fact specific, the *Residential Capital* decision should support secured creditors' attempts to recover default interest where they are able to demonstrate that any harm incurred by unsecured creditors as a result of the payment of default interest is limited and the secured financing assisted in the debtor's reorganization.

If I Am Entitled to Default Interest, What Rate Will a Court Apply?

The great majority of courts have held that the applicable default rate specified in the loan agreement should govern. On the other hand, courts will not insert a default rate into an agreement where not previously present.¹² Although the debtor generally bears the burden of rebutting the presumptive "contract rate," contract rates may be rebutted if the debtor demonstrates that there is no justification for the high rate and the rate is "inordinately high in relation to the non-default rate."¹³

Courts tend to either grant default interest at the rate specified in the underlying agreement or deny the request in full, but courts rarely determine a different applicable rate on their own where a specific rate has been previously agreed to between the parties.¹⁴ Where an objection is asserted against payment, as part of its equitable review, courts often require an evidentiary hearing to determine the rate's commercial reasonableness.¹⁵

Does it Matter What Type of Default Triggers the Right to Default Interest?

While it may be self-evident to state that default interest may only occur following an event of default, the specific type of default and the contractual default mechanics may have a profound effect on whether default interest will be allowed. For example, to the extent that declaring a default and acceleration is not automatic and the creditor fails to make an election prior to a bankruptcy filing, courts have held that the automatic stay will prohibit a creditor from delivering or rescinding default notices and no default interest will be due.¹⁶

In addition, some courts have denied default interest when the only existing default is the actual filing of the bankruptcy

petition itself, holding that, pursuant to § 365(e) of the Bankruptcy Code, such defaults are impermissible *ipso facto* clauses and not capable alone of invoking the contract default interest rate.¹⁷ For instance, the Bankruptcy Court in *Residential Capital* declined to grant post-petition interest at the default rate for the 16 day period between the debtors' May 14 bankruptcy filing date and the loan's May 30 maturity date because the debtor had been current on the loan upon the petition date. While the court did not allow for default interest to accrue solely on account of the bankruptcy filing, it did provide for interest to commence accruing following the default resulting from debtor's failure to pay the underlying debt on the maturity date. Other courts, such as *General Growth*, however, have come to different conclusions and allowed for payment of default interest commencing on the petition date on account of the bankruptcy filing.

In most instances, these decisions appear to turn upon whether the underlying credit agreement is deemed an executory contract (where both, not one, of the parties have remaining obligations outstanding), as the prohibition against *ipso facto* clauses applies only to executory contracts. For instance, a revolving loan may be deemed to be an executory contract because both the lender and borrower have remaining obligations, whereas a fully funded term loan or bond indenture may be deemed to be non-executory because the lender may have fulfilled all of its obligations. Where, as in *General Growth*, a credit agreement is determined to be non-executory, courts have allowed claims for default interest to begin accruing on the petition date. However where, as in *Residential Capital*, the agreement is deemed to be executory, courts have only allowed default interest to begin accruing after a separate default occurs.

Am I Entitled to Default Interest on the Entire Principal Balance?

Although in most circumstances, a secured creditor should be entitled to a claim for default interest on the entire principal balance, secured creditors should be aware of several potential limitations. As mentioned above, to the extent a loan agreement does not provide for the automatic acceleration of the loan upon a bankruptcy filing, the secured creditor's right to claim default interest may be limited. Thus, in *Northwest Airlines*,¹⁸ the court held that because lender had not accelerated the debt prior to the bankruptcy filing and the loan agreement did not contain an automatic acceleration provision upon a bankruptcy filing, the lender did not have the right to charge default interest on the entire loan amount and allowed default interest to accrue only on the unpaid installments.

In addition, at least one court has held that secured creditors may claim default rate interest only to the extent that they can present clear evidence of their oversecured status for the entire period that interest is sought.¹⁹ In *SW Boston*, the debtor owned real estate upon which Prudential held a security interest. The debtor sold the property during the

bankruptcy proceeding at a price greater than Prudential's secured claim and all parties agreed that Prudential was oversecured following the sale. The court was asked whether default interest should be paid for the pendency of the bankruptcy case (i.e. treating Prudential as oversecured for the whole case) or whether it should only be treated as oversecured for the post-sale period. After several appeals, the First Circuit held that, because Prudential failed to provide any evidence to meet its burden of showing that it was oversecured for the entire pendency of the case, Prudential was only entitled to default interest from the date of the sale until confirmation of the debtor's plan of reorganization.²⁰

Am I Entitled to Allowance of Late Payment Premiums?

Although credit agreements sometimes require the payment of both default interest as well as late payment charges and other type of fees following a default, it is well-established that an oversecured creditor may receive payment of either default interest or late charges, but not both.²¹ Secured creditors should be careful to elect the type of fee or interest that is preferable at the commencement of a case, as any choice will likely be difficult to change later.²²

Conclusion

Secured creditors or purchasers of secured claims should not assume that their claims will include default rate interest. Rather, whether secured creditors will receive default rate interest as part of their allowed claim is dependent on the relevant facts and circumstances, including the language of the credit agreement, the rate of interest and the nature of the default giving rise to the default rate interest. The allowance of default rate interest may also be dependent on the impact of such allowance on unsecured creditors. Therefore, legal and factual due diligence may be necessary to more accurately predict the likelihood that default rate interest will be allowed.

For More Information

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1. See *In re Milham*, 141 F.3d 420, 423 (2d Cir. 1998) ("Prepetition interest is generally allowable to the extent and at the rate permitted under the applicable nonbankruptcy law, including the law of contracts.").
2. *In re 785 Partners LLC*, 470 B.R. 126, 131 (Bankr. S.D.N.Y. 2012); *In re Northeast Industrial Dev. Corp.*, Case No. 13-37619 at p. 29 (Bankr. S.D.N.Y. July 29, 2014) (finding that

equitable considerations should not be taken into account when dealing with prepetition interest claims).

3. *In re 785 Partners LLC*, 470 B.R. at 132 ("[e]ven where the default rate strikes the judge as high [in this case 10%], a court cannot rewrite the parties' bargain based on its own notions of fairness and equity."); *In re 400 Walnut*, 473 B.R. 603, 610 (2012) (allowing 16% interest rate).
4. Section 506(b) of the Bankruptcy Code provides that an oversecured creditor is entitled to "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement ... under which such claim arose." 11 U.S.C. § 506(b).
5. *In re Gen. Growth Properties, Inc.*, 451 B.R. 323, 328 (Bankr. S.D.N.Y. 2011).
6. *Id.* at 328.
7. See *In re SW Boston Hotel Venture, LLC*, 748 F.3d 393, 415 (1st Cir. 2014).
8. See *General Growth Properties, Inc.*, 451 B.R. at 328 (court determined that, because the debtor was "exceedingly solvent," payment of default interest would neither inflict harm on other unsecured creditors nor impair the debtors "fresh start.").
9. See *In re Sultan Realty, LLC*, 2012 WL 6681845 (Bankr. S.D.N.Y. Dec. 21, 2012).
10. *In re Bownetree, LLC*, 2009 WL 2226107 (Bankr. E.D.N.Y. July 24, 2009).
11. See *General Growth*, 451 B.R. at 326; *In re Campbell*, 2014 WL 3734693 (Bankr. S.D.N.Y. July 29, 2014) (denying default interest on equitable grounds in the chapter 13 context).
12. See *Gen. Electric Capital Corp. v. Future Media Prods. Inc.*, 536 F.3d 969, 974 (9th Cir. 2008); *In re Vest Associates*, 217 B.R. 696, 702-03 (Bankr. S.D.N.Y. 1998); *In re Dow Corning Corp.*, 456 F.3d 668, 679-80 (6th Cir. 2006), citing *In re Southland Corp.*, 160 F.3d 1054, 1059-60 (5th Cir. 1998); *In re Woodmere Invs. Ltd. P'ship*, 178 B.R. 346, 355 (Bankr. S.D.N.Y. 1995).
13. See *In re Vest*, 217 B.R. at 702.
14. But see, *In re Haldes*, 503 B.R. 441, 447 (Bankr. N.D. Ill. 2013) (court held that creditor failed to provide any analysis to substantiate a 16.25% contract default rate; rate reduced by court to 10.25% based on average commercial lending rate).
15. See, e.g., *In re Lighthouse Lodge LLC*, 2010 WL 4053984 at *5 (N.D. Cal. Oct. 14, 2010).
16. See *In re Payless Cashways, Inc.*, 287 B.R. 482 (Bankr. W.D. Mo. 2002) (absent some affirmative action to accelerate debt, creditor could not charge default interest rate).
17. See *In re IT Group, Inc.*, 302 B.R. 483, 487 (D. Del. 2003); *In re Bownetree*, 2009 WL 2226107 at *2-3.
18. *In re Northwest Airlines Corp.*, 2007 WL 3376895 (Bankr. S.D.N.Y. Nov. 9, 2007).

19. *In re SW Boston Hotel Venture, LLC.*, 748 F.3d at 411.

22. See *In re Sagamore Partners, Ltd.*, 512 B.R. 296, 318 (S.D. Fl. 2014).

20. *Id.* at 410.

21. See *In re 785 Partners LLC*, 470 B.R. at 137; *In re 1095 Commonwealth Ave. Corp.*, 204 B.R. 284, 305 (Bankr. D. Mass. 1997).

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