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From the Bankruptcy Courts: When an Oversecured Creditor Is Entitled to Postpetition Interest at the Default Rate: The Thirty-Six Percent Award

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WHEN AN OVERSECURED CREDITOR IS ENTITLED TO POSTPETITION INTEREST AT THE DEFAULT RATE: THE THIRTY-SIX PERCENT AWARD

In general, interest that accrues after the filing of a petition for relief under the Bankruptcy Code is not allowable in the bankruptcy case.[1] The accrual of interest stops when the case is commenced. However, the Bankruptcy Code provides an exception whereby postpetition interest may be recovered by the holder of a secured claim in certain circumstances.[2] When the value of the collateral, after deducting any reasonable expenses that the trustee or debtor in possession may recover for preserving or disposing of the property,[3] exceeds the amount of the secured creditor's allowed claim, the secured creditor will have an allowable claim for postpetition interest that accrues during the bankruptcy case to the extent of the excess collateral value. In addition, an oversecured creditor has an allowable claim for any reasonable fees, costs, or charges, including attorney fees, provided for in the loan agreement. In no event may the creditor's claim for postpetition interest and fees exceed the excess value of the collateral over the amount of the claim.

Most courts agree that the appropriate rate of postpetition interest applicable to an oversecured creditor's claim is the rate set forth in the contract.[4] However, financial contracts often provide for a basic interest rate that will apply while the borrower is in compliance with the agreement, and a higher rate of interest that will apply if the borrower defaults on its obligations. The justification for a separate default rate is the need to compensate lenders for increased risk and costs (both predictable and unpredictable) of monitoring a loan in default situations. If the conditions to the default rate of interest have

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[1] See 11 U.S.C. § 502(b)(2).

[2] 11 U.S.C. § 506(b).

[3] See 11 U.S.C. § 506(c).

[4] If there is no contract rate, the rate provided under applicable nonbankruptcy law would govern.

been triggered, will the bankruptcy court allow the oversecured creditor to recover the default rate of interest?

Courts that have addressed the question of whether to apply the default rate, rather than the basic contract rate, often begin their analysis with a presumption that oversecured creditors are entitled to the contractual default rate, if enforceable under nonbankruptcy law, subject to rebuttal based on equitable considerations. These equitable considerations were recently examined in *In re Dixon*,[5] a case in which a federal district court in West Virginia allowed an oversecured creditor to recover, as part of its allowed claim in a bankruptcy case, interest at the contractual default rate of thirty-six percent.

The Facts

In *Dixon*, Dixon Development Group, Inc. ("DDG"), a corporation owned by Glenn S. Dixon ("Debtor"), was a borrower under a loan agreement with Florida Asset Financing Corporation ("Lender"). The principal amount of the loan was $150,000. The terms of the loan documents provided for basic interest at the rate of eighteen percent, late charges for delinquent payments at five percent and, upon default, a default rate of interest of thirty-six percent. The obligations of DDG under the loan documents were guaranteed by the Debtor. Also in connection with the loan, DDG and the Debtor executed separate security agreements in favor of the Lender granting security interests in certain real property, shares of stock, inventory, accounts, and equipment, among other things, valued at approximately one million dollars.

Approximately ten months after executing the financing agreement, DDG defaulted under the terms of the financing agreement. The Debtor subsequently filed for chapter 11 protection. The Lender filed a proof of claim in the Debtor's bankruptcy case setting forth the principal amount due on the loan, late fees of five percent accrued up to the time of default, and interest running at thirty-six percent thereafter. The Debtor objected to the Lender's proof of claim on the basis that the thirty-six percent interest rate was punitive in nature and, therefore, barred under the Bankruptcy Code.

Agreeing with the Debtor, the bankruptcy court held that the default interest rate of thirty-six percent was not interest, but rather was in the nature of a penalty and punitive. Furthermore, the bankruptcy court held that the Lender had not introduced evidence to support the particular default rate nor otherwise shown it to be commercially reasonable. Consequently, the bankruptcy court found the interest rate excessive and reduced the Lender's claim to the pre-default rate of eighteen percent.

District Court Reverses

On appeal, the district court reversed the bankruptcy court's deci-

[5] 228 B.R. 166 (W.D. Va. 1998).

sion. Commenting that the Bankruptcy Code and the legislative history of section 506(b) do not provide guidance as to the appropriate rate of interest applicable to an oversecured creditor's claim, the district court began its analysis by stating that:

> The majority of jurisdictions allow, or at least give "a presumption to the allowability of, default rates of interest, provided that the rate is not unenforceable under applicable nonbankruptcy law."[6]

Courts that have addressed the issue also acknowledge that certain circumstances might require an equitable deviation from the contractual default interest rate. "Unfortunately, 'there is no clear, emerging definite enumeration of [the] special circumstances or equitable considerations' which mandate an equitable deviation from the contractual default interest rate."[7] The district court noted that the Supreme Court had not addressed the rate of interest issue under section 506(b), nor has a consensus developed among the courts of appeals.

The district court then examined *United States v. Ron Pair Enterprises, Inc.*,[8] a decision by the United States Supreme Court holding that an oversecured creditor's right to postpetition interest under section 506(b) exists even if there is no underlying contract providing for interest on the claim.

> By opining that "[r]ecovery of postpetition interest is unqualified" and not reliant on a consensual agreement, whereas recovery of fees, costs, and charges is qualified by the twofold requirement that they be provided for in an agreement and meet a reasonableness test, the Court interpreted the statute to yield two distinct types of recovery.[9]

However, the *Ron Pair* decision was limited to the issue of entitlement to postpetiton interest. The Supreme Court did not decide what the appropriate rate of interest should be.

Although the award of postpetition interest is in part governed by equitable principles,[10] the Bankruptcy Code provides oversecured creditors with certain statutory rights to interest. As the Supreme Court noted in Ron Pair, the legislative intent behind formulating the Bankruptcy Code to include the unqualified entitlement to postpetition interest in section 506(b) was to "codif[y] creditors' rights more clearly than the case law . . . [b]y

[6] Id. at 172 (quoting 4 Collier on Bankruptcy ¶ 506.04[2][b][ii] at 506-114).

[7] Id. at 173 (quoting In re Hollstrom, 133 B.R. 535, 539 (Bankr. D. Colo. 1991)).

[8] 489 U.S. 235 (1989).

[9] 228 B.R. at 171 (quoting 489 U.S. at 241-242).

[10] The Seventh Circuit has noted that "[w]hat emerges from the post-Ron Pair decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations." 228 B.R. at 173 (quoting In re Terry Ltd. Partnership, 27 F.3d 241, 243 (7th Cir. 1994)). The Fifth Circuit has adopted a comparable standard, holding that the determination of whether to apply the default rate, rather than the pre-default rate, would be ultimately decided by looking beyond the contract to examine the equities involved. 228 B.R. at 173.

defin[ing] the protections to which a secured creditor is entitled, and the means through which the court may grant that protection."[11] Thus, within the exercise of its equitable powers, it is clear that a bankruptcy court may not act so as to burden the statutory rights of oversecured creditors.

The district court stated further that "default rates of interest do not enjoy, however, the same straightforward treatment that postpetition interest claims for basic interest do generally."[12] In the absence of a consensus among the courts as to the treatment of default interest and the circumstances under which recovery is appropriate, the district court fashioned a general rule to govern its consideration of the case:

> where the circumstances necessitating an equitable deviation are plainly absent and the contract interest rate does not violate state usury laws, function as a penalty, or exceed the value of the collateral, the presumption in favor of the contract rate has not been rebutted. To do otherwise is to impinge on a creditor's statutory rights under section 506(b).[13]

[11] 228 B.R. at 173 (quoting 489 U.S. at 248 (quoting H.R. Rep. No. 95-595, at 4-5 (1977)).

[12] 228 B.R. at 172.

[13] 228 B.R. at 174. The district court found support for its reasoning in Ruskin v. Griffiths, 269 F.2d 827, 831-32 (2d Cir. 1959), a case involving similar facts in which the Second Circuit held:

> In the bankruptcy context, where the debtor is solvent and, therefore, the unsecured creditors would not be harmed by the imposition of a higher interest rate and the contest over default interest involves only a creditor and a stockholder/debtor, payment of the default rate of interest may be proper.

228 B.R. at 174.

Equitable Considerations

The district court then examined existing case law to determine the relevant equitable considerations. First, the district court discussed the need to balance the equities between debtor and creditor. Within this factor, a court must equitably adjust contending creditors' claims and rights, and effectuate a fair distribution of a debtor's property among those creditors.[14] Quoting another bankruptcy court, the district court stated:

> It is reasonable to conclude that an excessive default interest rate imposed by a secured creditor serves as a penalty, or hammer . . . as against other creditors, not the debtor, and specifically against unsecured creditors. This is particularly true in a bankruptcy situation where the unsecured creditors are already probably taking a substantial hit on their claims.[15]

Due to the enactment of section 506(b) and the statutory right it cre-

[14] Id. at 175. See, e.g., In re Maywood, Inc., 210 B.R. 91, 93 (Bankr. N.D. Tex. 1997) (precluding default interest on the equities of the case and noting that it was "unclear whether the unsecured creditors . . . [would] receive any distribution whatsoever"); In re Consolidated Properties Ltd. Partnership, 152 B.R. 452, 458 (Bankr. D. Md. 1993) (precluding default interest on the equities and noting that collection of the default interest rate and late charges would at be "at the expense of junior creditors"); In re Hollstrom, 133 B.R. 535, 541 (Bankr. D. Colo. 1991) (holding that a court is to be guided by the Bankruptcy Code, applicable case law, the facts of the case, and "the equitable principles of distribution among creditors in bankruptcy").

[15] 228 B.R. at 175 (quoting In re Hollstrom, 133 B.R. at 541).

ates to postpetiton interest, the district court found it questionable whether other creditors' rights impact the determination of the appropriate rate of interest. In fact, the Supreme Court in *Ron Pair* noted that, "[a]lthough the payment of postpetition interest is arguably somewhat in tension with the desirability of paying all creditors as uniformly as practicable, Congress expressly chose to create that alleged tension. There is no reason to suspect that Congress did not mean what the language of the statute says."[16] Nonetheless, there were no junior creditors, secured or unsecured, in the *Dixon* case who would have been prejudiced by the Lender collecting the default interest rate. The Debtor had the money necessary to settle the Lender's claim set aside in an escrow account, and those funds were not needed to satisfy other creditors.

The district court also considered the equitable balance between the Lender and the Debtor. The premise of this consideration is that a secured creditor's rights may be more restricted in bankruptcy because of the policy of giving a debtor an opportunity to reorganize. However, the district court found this consideration inapplicable in the *Dixon* case because there was no evidence that suggested that satisfaction of the Lender's claim would unduly burden the Debtor's financial state of affairs or reorganization efforts.

Another equitable concern is that the default interest rate may function as "a coercive penalty rather than a bargained for attempt to compensate a creditor for its extra costs after a default."[17] Where the default rate is designed to coerce performance, rather than as a means of compensating the non-breaching party, the default interest rate is deemed a penalty, and it is inequitable to allow a penalty to affect the debtor's chance of reorganization or burden other creditors.

The district court held that a default rate may not be deemed a penalty against other creditors, where, as is the case in *Dixon*, no creditors will be damaged by awarding the claim and no evidence exists to indicate the Lender intended the default rate as a means of coercing payment. The district court reasoned that, as the thirty-six percent default rate was within the bounds of state usury law, the bankruptcy court's characterization of the default rate as "exorbitant" or noting that it is a large increase from the non-default rate is not enough, without other evidence, to render it a penalty. The district court found it sufficient that the Lender represented to the court that the default rate was proportionate to the reasonably anticipated damages resulting from a default by the Debtor. "While a thirty-six percent interest rate is high, the courts do not have plenary power to alter commercial contracts or to substitute

[16] 489 U.S. at 246-46.

[17] 228 B.R. at 175 (quoting In re Consolidated Properties Ltd. Partnership, 152 B.R. 452, 455 (Bankr. D. Md. 1993)).

their judgment for that of the parties."[18]

The district court acknowledged that some courts, including the bankruptcy court in this case, have required creditors to provide some affirmative justification for the default interest rate, either through demonstrated need or industry practice. The district court disagreed with these courts, stating that such a per se rule "seems to go against the purpose behind the use of default rates" and would unnecessarily burden the statutory rights of the Lender.[19] "Default interest rates are used as a means of compensating a lender for the unpredictable and hard to quantify administrative expenses and inconvenience in monitoring untimely payments. 'The costs incurred in performing this task vary from case to case and simply cannot be provided for beforehand.'"[20] In the presence of some or all of the above mentioned equitable circumstances, the majority of courts have required some affirmative showing of reasonableness by the creditor in order to recover postpetition interest at the default rate.[21] The district court did not require the Lender to make an affirmative showing of reasonableness because there were no equitable considerations necessitating a deviation from the default interest rate.

In reaching its conclusion to award default rate interest under the facts of the case, the district court was not unmindful of the "cure rationale" evoked by the Ninth Circuit in *In re Entz-White Lumber & Supply, Inc.*[22] There the court of appeals held that a debtor may defeat a creditor's claim for interest at the default rate by fully curing the default. By curing, the debtor was able to avoid all adverse consequences of the default, including the obligation to pay default rate interest. Under that rationale, the debtor may avoid default rate interest by providing in a Chapter 11 plan that the debt will be cured and reinstated so that it will be fully paid upon maturity. However, this cure rationale was inapplicable in *Dixon* because the district court found that the Debtor did not cure the default in that case.

In sum, the district court in *Dixon* held that the bankruptcy court's disallowance of the default interest rate was unwarranted because (i) the thirty-six percent default interest rate was not usurious under applicable state law, (ii) the interest sought by the Lender, when added to the principal amount of its claim, did not exceed the value of the collateral securing the claim, and (iii) equi-

[18] 228 B.R. at 178

[19] 228 B.R. at 174 n. 8.

[20] Id. (quoting In re Terry Ltd. Partnership, 27 F.3d at 244).

[21] Id. at 176. See, e.g., In re Terry Ltd. Partnership, 27 F.3d at 243-44; In re Consolidated Properties Ltd. Partnership, 152 B.R. at 457; In re Hollstrom, 133 B.R. at 539-40. "Where the default rate of interest cannot then be justified by the creditor, either by showing a 'demonstrated need or by prevailing industry practice,' the courts have deferred to the non-default, contract interest rate." 228 B.R. at 176 (quoting In re Terry Ltd. Partnership, 27 F.3d 241, 244 (7th Cir. 1994)).

[22] 850 F.2d 1338 (9th Cir. 1988).

table circumstances necessary to allow a court to deviate from the contract default rate did not exist. "The Code and applicable case law, facts of the case, and equitable principles of distribution compel that Dixon should be held to the contract default rate of interest provided in the note. To find otherwise here would render a windfall to the debtor."[23]

[23] 228 B.R. at 176.