Oversecured Lenders Face Difficulty in Collecting Default Interest in Bankruptcy

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It has been said that “‘[i]n a bankruptcy case, interest is the tail of the dog, but it is a long tail and it wags a lot.’” In re Milham, 141 F.3d 420, 421 (2d Cir. 1998) (quoting Dean Pawlowic, Entitlement to Interest Under the Bankruptcy Code, 12 Bankr. Dev. J. 149, 150 (1995)). In this regard, interest in bankruptcy cases may be allowed in predominately three circumstances: first, there is interest that accrues prior to the bankruptcy filing date (“petition date”), the allowance of which is determined by applicable non-bankruptcy law. 11 U.S.C. §502(b)(1), (2); second, there is interest that must be paid during a reorganization plan, typically for the purpose of providing secured or priority tax creditors, or even general unsecured creditors for that matter, with the present value of their claims as of the effective date of the plan. See e.g. 11 U.S.C. §§1129(a)(9)(C), 1129(b)(2)(A)(i)(II), 1129(b)(2)(B)(i), 1325(a)(5)(B)(ii); and third, there is interest that accrues postpetition, i.e., after the petition date (known as “pendency interest”), most commonly to a secured creditor whose collateral is greater in value than the amount of its debt – a so-called oversecured creditor.

An oversecured creditor is required to be paid pendency interest in bankruptcy cases pursuant to Bankruptcy Code §506(b), which provides that a creditor with that fortunate status is entitled to “interest on [its] claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.” However, nowhere in §506(b) or elsewhere in the Bankruptcy Code does it specify the rate of interest that is supposed to accrue to the oversecured creditor. It has thus been up to the courts to make that determination, which will be governed by federal, not state law. See In re Wonder Corp., 72 B.R. 580, 588 (D. Conn. 1987) (postpetition attorneys’ fees under §506(b) determined under federal bankruptcy law); In re VMC Real Estate, LLC, 2012 WL 836724, at * 3 (Bankr. D. Conn. Mar. 9, 2012) (postpetition fees and costs under §506(b) governed by federal law); In re Cummins Utility, L.P., 279 B.R. 195, 201 (Bankr. N.D. Tex. 2002) (standard for allowance of postpetition interest under §506(b) established by federal law).

Although not an entitlement, most courts have awarded pendency interest to oversecured creditors at the contract rate. See Milham, 141 F. 3d at 423 (2d Cir. 1998). Ultimately, however, it lies “within the limited discretion of the court” to determine what rate of interest to allow. Id. Thus, as to whether pendency interest may be awarded at the contract default rate, courts have applied a “rebuttable presumption that the oversecured creditor is entitled to default interest at the contract rate subject to adjustment based on equitable considerations.” In re 785 Partners LLC, 470 B.R. 126 134 (Bankr. S.D.N.Y. 2012).
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Recently, the Connecticut district court took up the question of whether to allow default interest to an oversecured creditor in O’Brien v. Presidents Holdings, LLC, Civ. No. 13-cv-625 (JBA) (D. Conn. Feb. 10, 2014). Based on prevailing case law in this Circuit, it identified the following limited situations where reducing the contract default rate would be appropriate:

where the secured creditor is guilty of misconduct, the application of the contractual interest rate would harm the unsecured creditors or impair the debtor’s fresh start or the contractual interest rate constitutes a penalty.

Id. at 8.

In O’Brien, the debtor’s bankruptcy estate appeared to be insolvent, such that each dollar of default interest (which was at 24%) paid to the secured lender would reduce the recovery to the debtor’s unsecured creditors. Based primarily on the harm that would result to unsecured creditors if the default interest rate were applied, combined with the magnitude of the default rate and the large spread between it and the non-default rate of 6.25%, the district court ruled that the default interest should be reduced to the highest amount that would still allow unsecured creditors to be paid in full. Id. at 12.

With O’Brien, there is now compelling authority in this district that in bankruptcy cases, oversecured lenders will be denied pendency interest at the default rate where the debtor’s estate is insolvent and the rate is deemed excessive as well as disproportionate to the non-default rate. Although O’Brien is a Connecticut district court decision, its holding technically may not be binding on bankruptcy courts in this district based on the view that district court decisions in a multi-judge district are not binding on bankruptcy courts in the same district. See Daly v. Deptula (In re Carrozzella & Richardson), 255 B.R. 267, 272 (Bankr. D. Conn. 2000) (reasoning that because the decision of one district court judge is not binding on another judge in the same district, the bankruptcy court, as a unit of the district court, similarly should not be bound by the decision of a single district court judge). But see e.g. In re Bruno, 356 B.R. 89, 91 n. 1 (Bankr. W.D.N.Y. 2006) (“each bankruptcy judge in a district served by more than one U.S. District Court Judge is bound by stare decisis to obey the decision of any one of those District Court Judges in a like case until a different U.S. District Court Judge of the same district disagrees with his or her peer’s earlier decision, in which event each Bankruptcy Judge is free to go either way”).

Another possible basis for reducing or disallowing postpetition default interest is found in state law. Although federal law governs the determination of whether to award default interest under Bankruptcy Code §506(b), one of the stated grounds for disallowing it is if it “constitutes a penalty.” O’Brien, at 8.

In O’Brien, the default interest was not considered a penalty under New York law, but recent Connecticut decisions have taken the view that under Connecticut law, default interest will be considered an unenforceable penalty if it does not pass muster as an enforceable provision for liquidated damages. See
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Although, after *O’Brien*, oversecured lenders in Connecticut bankruptcy cases cannot take too much comfort in getting their postpetition default interest, the ruling and others like it may have a counterproductive effect. As explained by the Second Circuit in *Ruskin*, default interest,

can be beneficial to a debtor in that it may enable him to obtain money at a lower rate of interest than he could otherwise obtain it, for if a creditor had to anticipate a possible loss in the value of the loan due to his debtor’s bankruptcy or reorganization, he would need to exact a higher uniform interest rate for the full life of the loan.

*Ruskin*, 269 F.2d at 832. *Ruskin*, however, dealt with this issue of postpetition default interest when the debtor’s bankruptcy estate was *solvent*, a condition (albeit rare) which most courts agree would require postpetition default interest to be paid to the oversecured creditor.

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