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District court affirms bankruptcy court's award to secured creditor of post-petition default rate interest

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A recent decision of the Connecticut District Court awarded post-petition interest at the full default rate to a secured creditor. In *Official Committee of Unsecured Creditors of Latex Foam International, LLC, et al. v. Entrepreneur Growth Capital*, No. 21-cv-1311 (VLB) (D. Conn. March 8, 2023), Judge Vanessa Bryant of the United States District Court for the District of Connecticut affirmed the bankruptcy court's ruling that awarded contractual default rate interest to a secured creditor in the post-petition period.

In awarding contractual default rate post-petition interest to a secured creditor, the district court added clarity to the framework for this analysis, concluding that a court should look to "equitable considerations," particularly three key factors among the relevant circumstances. The decision also leaves open significant questions, including whether these equitable factors will turn into a settled three-part test that will be applied in future cases.

Background facts

The debtors owed approximately $9.3 million to their secured creditor, Entrepreneur Growth Capital, under a loan and security agreement. The loan agreement provided a contractual default interest rate of 3% in excess of the non-default interest rate.

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During the course of the bankruptcy case, the secured creditor moved for payment of its entire secured claim, including interest at the contractual default rate, which totaled approximately $238,000. The Official Committee of Unsecured Creditors objected to the secured creditor's motion.

The bankruptcy court granted the motion and awarded the secured creditor default interest plus a per diem accrual thereafter.

Bankruptcy court's ruling

The bankruptcy court found that (a) the secured creditor was oversecured; (b) as an oversecured creditor, the secured creditor was entitled to interest on its claim under 11 U.S.C. § 506(b); and (c) the loan agreement provided for an award of interest at the default interest rate. The bankruptcy court also noted that there is a presumption in favor of applying the contractual default rate, but that presumption should be balanced against any equitable considerations that may limit application of that rate.

District court's discussion of the equitable considerations

The district court began its analysis by noting that the language of section 506(b) of the Bankruptcy Code, which, in summary, permits a secured lender to collect "interest on [a] claim, and any reasonable fees, costs, or charges" in the post-petition period if: (i) the claim is oversecured; and (ii) the agreement under which a claim arises provides for the secured creditor to collect these amounts.

While the parties did not dispute that the secured creditor was oversecured, they did dispute "how much interest [the secured creditor] [was] entitled to receive." The district court noted that section 506(b) "does not state *how much* interest" should be awarded (emphasis added).

Due to the absence of any binding or persuasive authority, the district court relied on pre-bankruptcy code authority that applied equitable considerations to the analysis. In doing so, the district court held that the "instruction to balance the equities remains."

While the district court considered "all of the relevant circumstances," the court focused its analysis on three factors:

(1) whether the secured creditor is guilty of misconduct,

(2) whether the application of the contractual interest rate would harm unsecured creditors or impair the debtor's fresh start, and

(3) whether the contractual interest rate constitutes a penalty.

The district court found that each of these factors weighed in favor of awarding post-petition default rate interest to the secured creditor.

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No finding of misconduct

While the committee did not directly allege that the secured lender had engaged in misconduct — and the bankruptcy court made no such finding — the committee did make a number of "scattered allegations" about the secured lender that the district court rejected.

First, the committee asserted that the secured creditor was an "opportunistic investor, [that] purchased the loan at a discount" and argued that, as a result, it would be unfair for the secured lender to receive the benefit of default interest under section 506(b). The district court found this argument was both unsupported by legal authority and unpersuasive. The reason was simple: The secured creditor was entitled to "rely[] on the provisions [of the loan agreement] that protect the value of the loan in the event of default (i.e., payment of default interest)."

Latex Foam *makes clear that oversecured creditors whose agreements provide for default rate interest may be entitled to default rate interest in certain circumstances.*

Second, the committee argued that the secured creditor was "hostile" to the debtors by refusing to provide post-petition financing or consent to the use of cash collateral, and exercising "tight control over the Debtors' operating budget" — while the secured creditor also received adequate protection payments and legal fees.

The district court rejected this argument as well, finding that: "[I]t is not hostile for a secured creditor to refuse to loan more money to a debtor in bankruptcy and try to limit the loss of its asset by using the tools the [Bankruptcy] Code provides." The district court also found that "[t]he fact that [the secured creditor] was not inclined to lend the Debtor money as a going concern is not an equitable justification for denying it the terms of the bargained-for default interest rate."

Harm to unsecured creditors

The committee's argument that the award of default interest to the secured lender resulted in harm to unsecured creditors was the primary dispute at issue in the appeal before the district court.

The district court found that the bankruptcy court "understood an award of default interest would harm unsecured creditors" because the Debtors were insolvent and any amount awarded to the secured creditor would result in fewer proceeds available to pay unsecured creditors. However, this in itself did not justify denying default rate interest.

Instead, the district court held that the question to be considered is not whether unsecured creditors are harmed generally, but, rather, whether they are *unduly* subordinated or harmed by a secured creditor's priority status.

In lieu of articulating a bright line legal test or standard for determining how much harm is sufficient to weigh against awarding post-petition default rate interest, the district court conducted a factual review of decisions that had awarded default interest as well as decisions that had denied default interest.

The district court suggested that the magnitude of the default interest and the size of the spread between the default rate and the contract rate are factors that should be considered. Because the magnitude of default interest and the size of the spread were not significant, the district court concluded that unsecured creditors were not unduly harmed by the default interest award to the secured lender and affirmed the bankruptcy court.

The default rate interest was not a penalty

The district court also affirmed the bankruptcy court's finding, which the committee did not challenge on appeal, that a 3% contract default interest rate spread is compensatory and does not constitute a penalty.

While the district court acknowledged case law suggesting that a significant spread between non-default and default interest rates could constitute a penalty, the 3% spread under the loan agreement was not wide enough. The district court observed that there are cases enforcing much higher default interest spreads of between 5% and 12%.

Other equitable considerations

The district court also considered the "circumstances surrounding the formation of the Loan Agreement" and found that they supported the award of default rate interest.

Here, the secured creditor's predecessor extended the loan to the debtors as exit financing from their previous bankruptcy, which supported the awarding of contractual default interest rate. "[P]roviding exit funding is encouraged because it furthers a key goal of the Bankruptcy Code — to allow a Debtor to reorganize and continue as a going concern when feasible."

The district court held that precedent to the contrary "would dissuade creditors from extending credit to debtors in bankruptcy to reorganize or to exact a higher interest rate and make it more difficult for debtors in bankruptcy to reorganize."

Conclusion

Latex Foam makes clear that oversecured creditors whose agreements provide for default rate interest may be entitled to default rate interest in certain circumstances. However, the decision leaves open at least three significant questions: (1) whether the equitable factors relied upon will turn into a settled three-part test that will be applied in future cases; (2) whether a secured creditor seeking an award of post-petition default rate interest will need to satisfy all three equitable factors — or only a majority; and (3) for the second factor (harm to unsecured creditors), how much harm is required for the factor to weigh against awarding default rate interest.

The writers are regular, joint contributing columnists on bankruptcy law for Reuters Legal News and Westlaw Today.

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