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Judicial Enforcement of Default Interest Rates

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INTRODUCTION

Although secured creditors use default interest rates to protect their security interest throughout the bankruptcy process, courts are not required to enforce those contractual provisions. Secured creditors can legitimately use default interest rates to provide an offset for the "costs and delay of the bankruptcy process."[1] Equitable considerations may require judicial nullification of default interest rates. Inequitable default interest rates directly contradict the policy goals of bankruptcy. The difficulty in determining the reasonableness of default interest rates results from competing policy interests within bankruptcy. Courts favor enforcing contractual obligations and preserving rights inside of bankruptcy, as they would have existed outside of bankruptcy. However, courts also value protecting a debtor's "fresh start" and the interest of all creditors within the bankruptcy process. For these reasons, it is important to understand the different justifications courts have used to enforce, or nullify, default interest rates.

Courts have analyzed several factors to determine whether it is equitable to enforce a default interest rate under section 506(b) of the Bankruptcy Code.[2] In *In re General Growth*

[1] *In re* USDigital, Inc., 461 B.R. 276, 290 (Bankr. D. Del. 2011).
[2] 11 U.S.C. § 506(b) ("There shall be allowed to the holder of such claim, interest on such claim.").

Properties Inc.,[3] the Bankruptcy Court for the Southern District of New York enforced a default interest rate that was 3% higher than the contractual interest rate.[4] The bankruptcy court determined that the debtor failed to produce persuasive evidence that enforcement of the default interest rate would produce an inequitable result.[5] The bankruptcy court noted that GGP was a solvent debtor, and the default interest rate would not impair GGP's "fresh start.[6] The bankruptcy court also placed a distinct value in enforcing the "expressly bargained for result" between the parties.[7] As a policy matter, it was further recognized that default interest rates help debtors attain loans with lower interest, because"[I]f 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."[8]

Practitioners can extract four factors that are important for the enforcement of default interest rates. First, the difference between the contractual interest rate and default interest rate are important under the court's analysis. In *GGP*, the parties stipulated to the fact that the default interest rate was not a penalty as a "stand-alone rate."[9] Second, a bankruptcy court's equitable power to alter default interest rates may nullify the contractual agreement. The bankruptcy court declined to use its equitable power to nullify the default interest rate because the default interest rate would primarily affect shareholders rather than unsecured creditors.[10] Third, creditors may not use default interest rates to deter bankruptcy filings. The debtor argued that the default

[3] 451 B.R. 323 (Bankr. S.D.N.Y. 2011).
[4] *Id.* at 331.
[5] *Id.*
[6] *Id.* at 328.
[7] *Id.* at 327–328 (citing Ruskin v. Griffiths, 269 F.2d 827, 832 (2d Cir. 1959) (stating that it would be the opposite of equity to allow a debtor to escape its contractual agreements).
[8] *Id.* (citing Urban Communicators PCS Ltd. P'ship v. Gabriel Capital, L.P., 394 B.R. 325, 340 (S.D.N.Y. 2008)).
[9] *Id.* at 328.
[10] *Id.*

interest rate was an invalid *ipso facto* clause, and the creditor used the default interest rate to penalize the debtor for seeking Chapter 11 relief.[11] However, the bankruptcy court rejected this argument. Fourth, the enforceability of default interest rate should be valid under state law.[12] Here, the creditor did not violate any state law.

Part I of this article will provide background information on default interest rates, including pre-Code case law and requirements for the enforcement of default interest rates. Part II analyzes section 506(b) of the Bankruptcy Code and case law, which determine whether courts should enforce a default interest rate. Finally, Part III attempts to summarize general principles that bankruptcy petitioners should remember when drafting loan agreements that could least be construes as penalties.

I. BACKGROUND INFORMATION

Bankruptcy courts may rely on their equitable powers to modify contractual provisions, including default interest rates, to achieve the "appropriate result."[13] Prior to the Bankruptcy Reform Act of 1978, in *Vanston Bondholders Protective Committee v. Green*,[14] as a matter of equity, the Supreme Court stated, "[A]n allowance of interest on interest under the circumstances shown by this case would not be in accord with equitable principles governing bankruptcy distributions." However, the Second Circuit subsequently distinguished the Supreme Court in *Ruskin v. Griffiths*[15] because the debtor in *Vanston* was insolvent; whereas, in *Ruskin*, the debtor

[11] *Id.* at 329.
[12] *Id.* at 328 (stating that mortgagor's must pay default interest as long as it as applicable under state law).
[13] *See* 11 U.S.C § 105(a); *In re* Beaty 306 F.3d 915, 922 (9th Cir. 2002) ("[A] bankruptcy court is a court of equity and should invoke equitable principles and doctrines, refusing to do so only where their application would be inconsistent with the Bankruptcy Code.").
[14] 329 U.S. 156 (1946).
[15] 269 F.2d 827 (2d Cir. 1959).

was solvent.[16] Therefore, in *Ruskin*, the equitable result was to enforce the "expressly-bargained-for" agreement between the creditor and debtor when the debtor is solvent and can afford to pay the default interest rate.[17]

The Bankruptcy Code does not dictate when a default interest rate is unenforceable. In the Bankruptcy Reform Act of 1978, Congress passed section 506(b) of the Bankruptcy Code, which allowed secured creditors to receive interest on their secured claims only if the secured property was worth more than the secured claim.[18] Nonetheless, section 506(b) does not specify an appropriate default interest rate.[19] In *United States v. Ron Pair Enters., Inc.*,[20] the Supreme Court held that any type of secured creditor was entitled to post-petition interest but also failed to determine substantive guidelines for interpreting section 506(b).[21]

Accordingly, bankruptcy courts must determine the appropriateness of default interest rates based on the "facts and equities" of each case.[22] For example, bankruptcy courts, relying on their equitable power, may nullify contractual provisions that are penalties.[23] A "penalty" interest rate is usually found where the rate charged is not reasonably related to protecting the secured creditor from the risk of default. In *In re Phoenix Business Park Ltd. P'ship*,[24] the Bankruptcy Court for the District of Arizona held that a 24% default interest rate was an unenforceable penalty rate.[25] The court held that an increase of 14% from the contractual interest rate was

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[16] *Id.* at 831.
[17] *Id.* at 832.
[18] *See* 11 U.S.C. § 506(b).
[19] General Growth Properties, Inc., 451 B.R. at 326.
[20] 489 U.S. 235, 242 (1989).
[21] *Id.* at 248–49.
[22] Terry Ltd. P'ship v. Invex Holdings, N.V. (*In re* Terry Ltd. P'ship), 27 F.3d 241, 243 (7th Cir. 2004).
[23] *See In re* Oahu Cabinets, Ltd., 12 B.R. 160, 165 (Bankr. D. Hawaii 1981).
[24] 257 B.R. 517 (Bankr. D. Ariz. 2001).
[25] *Id.* at 523.

excessive because the default interest rate along with the attorney's fees and other costs were not correlated to the measurable costs of the bankruptcy process.[26]

II. DISCUSSION

Acknowledging the difficulty for creditors to estimate the cost associated with a bankruptcy proceeding, courts may presume that a default interest rate is reasonable.[27] Nonetheless, in determining the reasonableness of default interest rates, courts should take a "hard look" at the circumstances.[28] The growing consensus among courts is to enforce a contract among the parties, notwithstanding equitable considerations.[29] The Ninth Circuit noted, "The purpose of [default] interest is to compensate for the loss of monetary value, while a penalty is typically charged for a failure to act by a certain deadline."[30] Creditors should only use default interest rates to compensate themselves for the administrative expenses and inconvenience of the bankruptcy process.[31]

The factual evidence of the case must support the inference that a default interest rate is reasonable as it relates to defer a creditor's costs during the bankruptcy process.[32] Default interest rates that appear arbitrary should not be enforceable, and courts may rely on their equitable power to alter these contracts.[33] Courts may consider state usury laws to determine

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[26] *Id.* at 522.
[27] *Id.*
[28] *In re* Casa Blanca Project Lenders, L.P., 196 B.R. 140, 148 (9th Cir. B.A.P. 1996).
[29] Lapiana v. Lee (*In re* Lapiana), 909 F.2d 221, 223 (7th Cir. 1990) ("[D]espite its equity pedigree, [bankruptcy] is a procedure for enforcing pre-bankruptcy entitlements under specified terms and conditions rather than a flight of redistributive theory."); General Growth Properties Inc., 451 B.R. at 328–329.
[30] *See In Re* Hovan Inc., 96 F.3d 1254, 1259 (9th Cir. 1996).
[31] *In re* Vest Associates, 217 B.R. 696, 701 (Bankr. S.D.N.Y. 1998).
[32] *In re* Schamburg Hotel Owner Ltd. P'ship, 97 B.R. 943 (Bankr. D. Ill. 1989).
[33] *Id.*

whether the default interest rate is reasonable. In *In re Urban Communicators Ltd. P'ship*,[34] the Bankruptcy Court for the Southern District of New York held that a default interest rate at 38% was unenforceable.[35] Although the agreement in this case was exempt from the New York criminal usury provisions, the bankruptcy court reasoned that state usury law provided a proper "benchmark." As a matter of policy, the court held that default interest rates should not be enforced if they exceed criminal usury laws.[36]

Although decisions involving default interest rates involve a detailed factual analysis,[37] courts generally look towards the same factors to determine whether the default interest rate is enforceable. These four factors, which I have summarized, include: (1) the difference between the contract interest rate and the default interest rate; (2) the extent of a court's equitable power to alter default interest rates; (3) the creditor's use of the rate as a penalty to deter a debtor from filing bankruptcy; and (4) the enforceability of the default interest rate under state law.[38] Additionally, the debtor's solvency is crucial in the court's determination.[39] When the post-petition debtor is solvent, the equitable result favors the enforcement of the default interest rate because the debtor's estate benefitted from the use of the creditor's money.[40]

A. DIFFERENCE BETWEEN THE CONTRACTUAL RATE AND DEFAULT RATE

No set standard exists to determine an inappropriate difference between the default interest rate and contract interest rate.[41] Nonetheless, a creditor has a greater chance for judicial

[34] 379 B.R. 232 (Bankr. S.D.N.Y. 2007).
[35] *Id.* at 256.
[36] *Id.* at 254.
[37] *In re* Johnson, 184 B.R. 570, 573 (Bankr. D. Minn. 1995).
[38] *See e.g.*, General Growth Properties, Inc., 451 B.R. at 327–30.
[39] *Id.* at 328.
[40] *In re* Downing Corp., 456 F.3d 668, 672 (6th Cir. 2005).
[41] *See* 11 U.S.C. § 506(b) (stating oversecured creditors may receive interest without specifying an interest rate).

enforcement of a default interest rate if the default interest rate is a slight increase from the contractual interest rate because a default interest rate should mirror a "charge."[42] In *In re Ace-Texas, Inc.*[43] the Bankruptcy Court for the District of Delaware held that a 2% default rate increase was not great enough to warrant judicial nullification of a default interest rate. The debtor failed to overcome the presumption that a default interest rate, which was a relatively minor increase from the contractual interest rate, should be enforced. However, in *In re Boulders on the River, Inc.,*[44] the Bankruptcy Court for the District of Oregon held that a default interest rate increase of 5% constituted an unreasonable penalty.[45] The court found that the default interest rate excessively compensated the creditor for the delay of the bankruptcy proceedings and did not adequately reflect compensation for delay in the bankruptcy process.[46] As a result of these factual determinations, the default interest rate was held to be unenforceable.

B. COURT'S EQUITABLE POWER TO ALTER DEFAULT INTEREST RATES

Bankruptcy courts rely on their equity power to nullify default interest rates that may unjustly affect unsecured creditors. For these cases, courts consider the justifications for and effects of applying a default interest rate. The Supreme Court has noted "[T]he touchstone of each such decision on allowance of interest in bankruptcy, receivership, and reorganization has been a balance of equities between creditor and creditor or between creditor and debtor."[47] In *In re Hollstrom,*[48] the Bankruptcy Court for the District of Colorado held that a 36% default interest rate was excessive. The court did not focus on the spread between the default interest rate and the

[42] 2012 WL 987288, *7 (Bankr. M.D. Tenn. 2012) (stating default interest should not be thought of as an interest rather it should be a "charge" for the delays of the bankruptcy process).
[43] 217 B.R. 719 (Bankr. D. Del. 1998).
[44] 169 B.R. 969, 973–74 (Bankr. D. Or. 1994).
[45] *Id.* at 975.
[46] *Id.*
[47] Vanston Bondholders, 329 U.S. at 165.
[48] 133 B.R. 535 (Bankr. D. Colo. 1991).

contractual interest rate. Rather, the court merely determined "too many creditors" were chasing "too few dollars," and the excessively high default interest rate allowed the secured creditors to penalize other creditors as opposed to the debtor.[49] Recognizing that bankruptcy policy allows debtors the "opportunity to reorganize," the court would not enforce a default interest rate that would prevent the debtor's "fresh start."[50]

A court's analysis may also turn on whether there are other unsecured creditors. In *In re Dixon,*[51] the Bankruptcy Court for the District of West Virginia held that a 36% default interest rate was enforceable in Chapter 11 reorganization.[52] This transaction involved a credit agreement between two sophisticated parties without the existence of any unsecured creditors.[53] Therefore, the court did not exercise its equitable power to alter a legal contract, which would not inhibit the debtor's reorganization process.[54] If this case involved other unsecured creditors, it is probable that the result would have been different.

C. CREDITORS USE OF THE DEFAULT INTEREST RATE TO DETER BANKRUPTCY FILINGS

Courts allow default interest rates as long as the creditor did not impose the default interest rate for an improper motive. Default interest rates that are "penalties" inherently deter debtors from filing for bankruptcy. The difference between the default interest rate and contractual interest rate does not matter for this analysis; the creditor's purpose and motive are dispositive. In *re Wolverine, Proctor & Schwartz, LLC,*[55] the Bankruptcy Court for the District

[49] *Id.* (comparing a 36% default interest rate to a "sledgehammer").
[50] *Id.*
[51] 228 B.R. 166 (W.D. Va. 1998).
[52] *Id.* at 177.
[53] *Id.*
[54] *Id.*
[55] 449 B.R. 1 (Bankr. D. Mass. 2011).

of Massachusetts held that a 2% default interest rate increase was not a penalty.[56] The default interest rate in this case was reasonable for two reasons. First, the default interest mirrored the potential lost time value of money;[57] second, it was a charge for the "extra costs incurred after default."[58] Additionally, the secured creditor did not combine a default interest rate with another provision intended to protect secured creditors from unforeseen delays in the bankruptcy process. In *In re AE Hotel Venture*,[59] the Bankruptcy Court for the District of Northern Illinois held that the creditor could not recover for certain contractual obligations, including default interest rates.[60] A creditor that combines default interest rates with another provision, which is intended to protect the creditor from the delay of the bankruptcy process, is seeking a "double recovery."[61] The prospect of paying excessive penalties may prevent the debtor from seeking bankruptcy relief.

A default interest rate may not merely attempt to add interest to a secured claim.[62] For example, in *In re Timberline Property*,[63] the Bankruptcy Court for the District of New Jersey held that a 3% default interest rate was unreasonable.[64] Even though the 3% increase could have presumably been appropriate, the creditor's employee testified that the default interest rate was designed to induce payments, showing that the intent of the default interest rate is exceedingly important.[65] The importance of testimony in these situations cannot be underestimated because the *Timberline* court relied specifically on testimony to come to its determination.

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[56] *Id.* at 6.
[57] *See id.*
[58] *Id.*
[59] 321 B.R. 209, (Bankr. N.D. Ill. 2005).
[60] *Id.* at 216.
[61] *Id.*
[62] *In re* Consolidated Properties Ltd. P'ship., 152 B.R. 452, 455 (Bankr. D. Md. 1993).
[63] 136 B.R. 382 (Bankr. D. N.J. 1992).
[64] *Id.* at 386.
[65] *Id.*

D. THE ENFORCEABILITY OF DEFAULT INTERST RATE UNDER STATE LAW

Courts have failed to mark a clear distinction between the practice of analyzing default interest rates under state law or federal law.[66] In *In re Skyler Ridge*,[67] the Bankruptcy Court for the Central District of California held that section 506(b) does not adopt any federal law standard to determine reasonable default interest rates. Instead, state law was used to determine that the default interest rate was unreasonable.[68] The court noted, "Any restriction on the contract rate of interest must thus come from state law, and not from bankruptcy law."[69] Nonetheless, this would not preclude bankruptcy courts from using their equity power under the *Vanston* rule, which restricts the use of default interest rates against insolvent debtors.[70] Others courts analyze the default interest rate as a federal issue involving bankruptcy. Courts justify this decision on the basis that bankruptcy law is a federal law, which may supplant state law.[71] In *In re W.S. Sheppley & Co.*,[72] the Bankruptcy Court for the District of Iowa held that state law may be considered, but in the "last analysis," federal law should be the final determination.[73] Accordingly, bankruptcy practitioners should analyze default interest rates under state and federal law.

III. CONCLUSION

Bankruptcy law allows equitable consideration of "contending creditor's claims and rights, and effectuate a fair distribution of a debtor's property among creditors."[74] Bankruptcy

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[66] *In re* W.S. Sheppley & Co., 62 B.R. 271, 278 (Bankr. D. Iowa 1986).
[67] 80 B.R. 500 (Bankr. C.D. Cal. 1987).
[68] *Id.* at 504.
[69] *Id.*
[70] *Id.*
[71] W.S. Sheppley & Co., 62 B.R. 271, 278 (Bankr. D. Iowa 1986).
[72] 62 B.R. 271 (Bankr. D. Iowa 1986).
[73] *Id.* at 278 (discussing elements of the conflicts of law debate and federalism).
[74] Hollstrom, 133 B.R. at 541.

practitioners should always remember that the reasonableness of default interest rates is determined by the individual facts of the case. As has previously been noted, courts will use testimony or other evidence to determine whether a default interest rate is reasonable. In *In re Route One West Windsor Ltd. P'ship*,[75] the Bankruptcy Court for the District of New Jersey held that the default interest rate in this case was enforceable based on the testimony of the creditor's vice president.[76] The court justified its decision by pointing to the testimony of the creditor's vice president who stated that every loan officer had the discretion to set a default interest rate as would be necessary to protect the creditor from the increased risk of a bankruptcy proceeding.[77] When bankruptcy practitioners litigate default interest rates, the focus should pertain to the justification for the default interest rates rather than the interest rate itself. Additionally, practitioners should not disregard a court's equitable power to nullify default interest rates given the fact that the Supreme Court used its equity power to nullify default interest rates prior to the current Bankruptcy Code.

[75] 225 B.R. 76 (Bankr. D. NJ. 1998).
[76] *Id.* at 89-90.
[77] *Id.*