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JULY/AUGUST 2014

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)

ISBN: 978-0-7698-7988-8 (eBook)

Cite this publication as:

[author name], [article title], [vol. no.] PRATT’S JOURNAL OF BANKRUPTCY LAW [page number] (LexisNexis A.S. Pratt);

Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the “Rescue and Recovery” Culture for Business Recovery*, 10 PRATT’S JOURNAL OF BANKRUPTCY LAW 349 (LexisNexis A.S. Pratt)

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*An A.S. Pratt™ Publication*

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# First Circuit Adopts Flexible Approach to Determine Amount of Post-Petition Interest to Be Paid to Oversecured Creditor

*Andrew Kamensky and David E. Bane\**

*Computation of post-petition interest is a frequent topic of debate among the courts. Recently, the U.S. Court of Appeals for the First Circuit in Prudential Insurance Co. of America v. SW Boston Hotel Venture, LLC, et al., confronted the issue and ruled that a bankruptcy court may adopt a flexible approach for determining the amount of post-petition interest payable to an oversecured creditor. The authors discuss the case and its implications.*

Although Section 506(b) of the Bankruptcy Code explicitly allows payment of post-petition interest to holders of oversecured claims (i.e., where the value of the collateral exceeds the amount of the claim), the Bankruptcy Code does not describe how to calculate it. No bright line rules exist dictating how to determine oversecured status, the timing of the valuation, and the rate and type of interest to be paid to oversecured creditors. Computation of post-petition interest is a frequent topic of debate among the courts. Recently, the U.S. Court of Appeals for the First Circuit in *Prudential Insurance Co. of America v. SW Boston Hotel Venture, LLC, et al.*,<sup>1</sup> confronted these issues and ruled that a bankruptcy court may adopt a flexible approach for determining the amount of post-petition interest payable to an oversecured creditor.

## CASE BACKGROUND

SW Boston Hotel Venture, LLC, (the “debtor” or “SW Boston”) sought financing to develop a mixed use property consisting of a hotel, condo units, restaurant, spa and bar. In 2008, Prudential Insurance Company (“Prudential”) agreed to provide over \$192 million in secured financing for the project. As collateral, SW Boston gave Prudential a first priority mortgage and security interest in SW Boston’s real and personal property and its proceeds. Prudential received additional collateral and credit support, including a \$17.3 million letter of credit (collectively, the “Prudential Loan”). The terms of the Prudential Loan required that SW Boston obtain Prudential’s consent before entering into any junior loans.

After experiencing financial difficulties, SW Boston needed additional financing to complete the project. When Prudential declined to make further loans to SW Boston, the debtor entered into a loan agreement with the city of Boston (the “City Loan”),

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<sup>1</sup> 1st Cir. April 11, 2014.

in which the city agreed to provide an additional \$10.5 million in funding. The City Loan was secured by a junior lien on most of the collateral securing the Prudential Loan. In exchange for providing its consent to SW Boston to obtain the City Loan, Prudential required that the city subordinate its right to payment to Prudential and assign to Prudential the city's right to vote on any bankruptcy plan.

In 2010, SW Boston (and a number of affiliated debtors) filed voluntary Chapter 11 bankruptcy petitions. Prudential filed a proof of claim for \$180.8 million, plus fees, costs and pre- and post-petition interest. Prudential would later draw down the letter of credit, reducing its claim to approximately \$165 million. Prudential filed a motion for stay relief on the grounds that it was undersecured. The bankruptcy court denied the stay relief motion, finding that the entire collateral package gave Prudential an equity cushion (i.e., the difference between the value of the allowed claim and the value of the collateral securing the claim). SW Boston sold the hotel in June 2011 and the proceeds were paid to Prudential. Meanwhile, the debtors filed their plan of reorganization. Prudential objected to the plan confirmation on multiple grounds, including that the plan did not provide for payment of post-petition interest. Prudential also moved for a determination that it was oversecured and entitled to post-petition interest under Section 506(b) of the Bankruptcy Code.

## **THE BANKRUPTCY COURT'S DECISION**

Prudential wanted post-petition interest to accrue from the petition date at the contract default rate of 14.5 percent, and not the base rate of 9.5 percent. SW Boston argued that Prudential became oversecured only when the hotel sale closed and post-petition interest should accrue at the lower base rate and be paid from the closing date. After holding a trial on the Section 506(b) motion and plan confirmation, the bankruptcy court awarded Prudential post-petition, non-compounding interest at 14.5 percent commencing on the hotel sale date. The bankruptcy court reasoned that because the debtors had made a number of improvements to the hotel post-petition, Prudential was entitled to post-petition interest only from the date of the sale of the hotel, which is the date the court found that Prudential became oversecured. In making this determination, the bankruptcy court discounted several other dates as to when Prudential became oversecured. For example, the bankruptcy court refused to utilize the plan confirmation date, the petition date or the date of a lift-stay decision. Prudential appealed the bankruptcy court's ruling to the Bankruptcy Appellate Panel for the First Circuit (the "BAP").

## **THE BAP REVERSES IN PART**

Upon consideration of the post-petition interest issue, the BAP found that Prudential was entitled to post-petition interest from the petition date, and reversed the bankruptcy court's determination that Prudential became oversecured only as of the hotel sale date. The BAP affirmed that the contract default rate of 14.5 percent applied, but reversed the bankruptcy court's finding that the post-petition interest was not compounding. SW Boston and the City of Boston appealed the BAP's

findings to the US Court of Appeals for the First Circuit.

### **THE FIRST CIRCUIT VACATES THE BAP DECISION**

As an initial matter, the First Circuit noted that the parties agreed that Prudential was oversecured during some part of the bankruptcy proceeding, and therefore, was entitled to some amount of post-petition interest. But, the parties disagreed as to how to determine the oversecured status, when Prudential became oversecured and the applicable interest rate (base or default) and type (simple or compounding). The First Circuit further stated that, “[a]lthough § 506(a) dictates how courts should determine secured status and collateral value, it does not specify the time as of which these determinations should be made.” Typically, the choice of a measuring date is not an issue when the value of collateral remains relatively constant throughout the bankruptcy case. However, the valuation timing issue may arise when the claim amount decreases significantly during the bankruptcy case and the value of collateral increases. This is exactly what happened in the instant case.

The First Circuit recognized the split in authority on the timing issue, with some courts adopting a “single-valuation” approach, where the determination of oversecuredness for Section 506(b) purposes occurs at a fixed point in time. Other courts have adopted a “flexible” approach, which gives the bankruptcy court discretion to determine the appropriate measuring date based on the unique circumstances of the case. In the instant case, although the bankruptcy court and the BAP both utilized the “flexible” approach, each applied a different measuring date. The First Circuit ruled that, at least under the circumstances of the instant case, a bankruptcy court may adopt a “flexible” approach. Upon applying the “flexible” approach, the First Circuit agreed with the bankruptcy court’s findings that Prudential had not met its burden of showing it was oversecured for Section 506(b) purposes at any time before the hotel sale date. Thus, the First Circuit vacated the BAP’s finding that Prudential was entitled to post-petition interest from the petition date and affirmed the bankruptcy court’s determination that Prudential became oversecured only as of the hotel sale date.

Having established that post-petition interest on the Prudential claim began to accrue at the sale date, the First Circuit next addressed how that interest accrued and analyzed the appropriate rate for the post-petition interest and whether the interest was simple or compound. With respect to the interest rate, the First Circuit stated that although most courts agree that the appropriate rate of post-petition interest is within the limited discretion of the court, where the parties have, by contract, agreed to a certain rate, that rate should apply as long as it is enforceable under state law and provided that there are no intervening equitable considerations.

Upon the First Circuit’s inquiry as to whether the default interest rate was within the limits set by Massachusetts law, the court found that the prescribed default rate did not exceed the maximum rate permitted by law. Second, the court examined whether the default interest provision constituted allowable liquidated damages or an unenforceable penalty. The party challenging a liquidated damages provision has the burden of showing that it is an unenforceable penalty. A liquidated damages

provision will be enforced provided, first, that at the time of contracting the actual damages from a breach were difficult to determine; and second, that the sum agreed to as liquidated damages was a reasonable forecast of damages for a breach. As such, it was SW Boston's burden to show that "the default rate was not reasonably related to anticipated damages and, in fact, was so grossly disproportionate to anticipated damages or otherwise unconscionable as to be unenforceable under Massachusetts law." In analyzing whether there were intervening equitable considerations, the First Circuit found that SW Boston had failed to rebut the presumption in favor of enforcing the contractual provision. Thus, the court found that the appropriate rate of post-petition interest was 14.5 percent, affirming both the bankruptcy court and the BAP on this issue.

Finally, the First Circuit had to determine whether the post-petition interest would be compound or simple interest. In its analysis, the court found that Prudential could not claim entitlement to compounding where it did not seek compound interest until after the bankruptcy court granted it post-petition interest at the default rate running from the date of the hotel sale. The court reasoned that "Prudential, having failed to give the bankruptcy court the opportunity to consider whether application of compound interest (even if the contract called for it) would have been equitable, can now be heard to complain that the court abused its discretion (or even erred) in disallowing compounding." Thus, the First Circuit reversed the BAP's ruling that Prudential was entitled to accrue post-petition interest at the default rate, compounding monthly.

## CONCLUSION

Although the *SW Boston* decision illustrates that the right to add post-petition interest to an oversecured claim is subject to a number of limitations, it provides secured creditors with comfort that their contractual rights for default interest upon a bankruptcy default are likely to be upheld, especially if the debtor is solvent. Because the flexible approach adopted by the First Circuit is an equitable inquiry, courts must examine the impact that awarding the contract default rate has on unsecured creditors. Finally, this opinion serves as a useful reminder that if a loan agreement provides for compounding interest, the prudent secured creditor should claim entitlement to it immediately to preclude any argument that it has been waived.