

Balancing the Equities: Default Interest Rate Adjusted as Bankruptcy Court Weighs in on Critical Issue

"You're in big trouble if you're borrowing more than you can afford to pay back" – Simon Cowell

Can a bankruptcy court apply its equitable powers to adjust the default rate for post-petition interest owed to over-secured creditors? The Bankruptcy Court for the District of Puerto Rico recently held that the Bankruptcy Code allows for a "balancing of the equities" in determining whether to apply a contractual default rate or a contractual non-default rate for interest accruing after the commencement of a bankruptcy case. In so holding, the Bankruptcy Court disallowed an over-secured creditor's claim of interest at the default rate, and instead applied the lower pre-default rate.

Facts

The relevant facts in *In re Manuel Mediavilla, Inc.* follow. Manuel Mediavilla, Inc. owned several commercial real estate properties, which it then leased to various businesses. To finance its operations, Manuel Mediavilla borrowed against its real properties, giving its lender a security interest in its real properties. The loan provided for a 5 percent pre-default interest rate and an 8 percent post-default rate.

The debtor, along with its owners, subsequently commenced bankruptcy cases under Chapter 11 of the Bankruptcy Code. As an over-secured creditor, its lender, PRLP 2011 Holding, LLC, was entitled to post-petition interest pursuant to section 506(b) of the Bankruptcy Code. But section 506(b) does not specify whether over-secured creditors are entitled to default or non-default interest. The debtor proposed a plan that would have paid PRLP interest at the 5 percent contractual pre-default interest rate, and PRLP objected, arguing that it was entitled to the higher default interest rate.

The Decision

In determining the proper interest rate to apply to the post-petition period, the Bankruptcy Court considered whether it should mandate that interest be paid at the higher contractual default rate because it was otherwise enforceable under state law, or whether the Bankruptcy Code

permitted the Bankruptcy Court to “balance the equities” and allow the non-default rate to apply to the post-petition period. The bankruptcy court noted that courts have generally fallen into three camps regarding the proper post-petition interest due to over-secured creditors:

- 1) The default rate is only limited by its enforceability under state law, and the default rate must apply to the post-petition period as long as such rate would be enforceable under applicable non-bankruptcy law;
- 2) A claim for interest at the default rate is not a claim for interest at all, but rather a “charge,” which must be “reasonable” under section 506(b); if the “charge” is not “reasonable,” it must therefore be adjusted; and
- 3) The Bankruptcy Court has an equitable power and duty to examine the facts and circumstances of each case and must determine whether to award default interest to over-secured creditors based on “notions of fairness and equity in determining whether to award default rate interest.”

After reviewing the three approaches, the Bankruptcy Court adopted the third so-called “majority” rule, and held that the equities of the case supported adjusting the post-petition interest rate due to PRLP because:

- After the debtor defaulted on the loan, PRLP did not enforce the contractual default rate;
- PRLP acquired the loan from the original lender with full knowledge of the debtor’s inability to comply with its loan obligations;
- Associated costs related to the debtors’ default were not incurred by PRLP;
- The default rate may function as a coercive penalty that affected the debtor’s possibilities of reorganization; and
- Application of the default rate would harm other creditors and allow PRLP to receive a windfall.

Based on the above, the bankruptcy court held that “the equities in this case” militated in favor of a reduction of the post-petition rate. Interestingly, the Bankruptcy Court’s descriptions of the particular facts and circumstances that led it to apply the non-default rate may prove instructive in determining whether, in other cases, over-secured lenders should be given the benefit of the duly negotiated default rate, or whether the Bankruptcy Court should invoke its equitable powers to reduce that interest rate based primarily on the court’s perceived equities of the case.

Practical Considerations:

The *Manuel Mediavilla, Inc.* decision reinforces the position taken by a growing majority of courts that Bankruptcy Courts may exercise their inherent equitable powers to override the plain language of a debtor’s loan documents. There is ample precedent for this approach (see, e.g. *In re Terry Limited Partnership*, 27 F.3d 241, 243 (7th Cir. 1994); *In re Laymon*, 958 F.2d 72, 75 (5th Cir. 1992); *In re Jack Kline Co., Inc.*, 440 B.R. 712, 745 (Bankr. S.D. Tex. 2010)), but reasonable minds could certainly disagree. For example, one can argue that section 506(b) of the Bankruptcy Code itself contemplates that payments to over-secured creditors are limited to that which is “reasonable.” But one could also argue that section 506(b) only applies a reasonableness standard to fees, cost, or charges, and not to the express terms of the loan documents regarding payment of interest and principal on such loan.

In any event, *Manuel Mediavilla* provides important guidance in determining the types of considerations that may be taken into account by the growing majority of courts that are willing to deny application of post-petition interest at the contractual default rate. After all, even courts that are willing to reduce that interest rate will only do so where such a reduction is consistent with the “equities of the case.”