November 6, 2017

What Lenders Need to Know About Interest Payments on Claims in Bankruptcy

By Valerie P. Morrison

How realistic is it for creditors to anticipate receiving interest on their claims in bankruptcy? The answer depends on whether the claim is secured or unsecured, whether interest is claimed for the period before or after the bankruptcy filing, and whether the debtor is solvent or insolvent, to name just a few considerations.

As a general rule, unsecured creditors are entitled to assert a claim for interest that accrued on their claims prior to the bankruptcy filing date ("pre-petition"), but are not entitled to assert a claim for interest accruing after the petition date ("post-petition"). Prepetition interest is typically allowed at the contract rate so long as the claim for interest is not unenforceable under a provision in their contract or applicable law (e.g. usury).

The Bankruptcy Code expressly disallows claims for post-petition interest. However, there is an exception available to unsecured creditors in chapter 7 cases where the debtor is solvent based upon another Bankruptcy Code provision that prohibits the return of surplus assets to a debtor unless and until all allowed unsecured claims are paid with interest at the legal rate. Thus in the admittedly rare case of a solvent chapter 7 estate, unsecured creditors are entitled to an award of post-petition interest on their claims at the legal rate. Courts have determined that the legal rate of interest is the federal judgment rate.
In chapter 11 cases involving solvent estates, many courts go further and will award post-petition interest on unsecured claims at the contract rate as opposed to the legal rate, which is often lower. In Chapter 11, the court must determine that a reorganization plan is fair and equitable to unsecured creditors in order to approve the plan. Many courts have determined that it is not equitable to deprive unsecured creditors of the contract rate of interest when the debtor is solvent. However, courts do reserve the right to impose a different rate based on case circumstances.

What about secured creditors? Do they fare any better than unsecured creditors? The answer is, typically, yes, but individual results may vary depending on several factors, including whether the creditor is oversecured or undersecured and also where the bankruptcy case was filed.

As with unsecured claims, secured claims are typically paid pre-petition interest at the contract rate. However, unlike unsecured claims, the Bankruptcy Code expressly permits the payment of post-petition interest to creditors who are oversecured up to the value of their collateral. Thus, the first determination to be made is whether the creditor is oversecured, which requires a determination of the value of the collateral securing the claim. If the collateral value exceeds the amount owed, the creditor is oversecured. If the value is less than the claim amount, the creditor is undersecured and is not entitled to post-petition interest.

Apart from the valuation of the collateral, which itself can be a complex and nuanced process, what many courts struggle with is the correct post-petition interest rate to apply to an oversecured claim. While courts generally apply the contract rate pre-petition, courts have different views on the applicable post-petition rate. In principal, most courts agree that oversecured creditors are entitled to receive post-petition interest at the contract default rate (if applicable), subject to the allowability of the rate under applicable nonbankruptcy law (e.g. usury) and further subject to adjustment on the basis of equitable considerations. Thus, assuming the contract rate is not usurious or otherwise prohibited, most courts will presume the contract rate applies unless equity dictates using a different rate.

Courts typically consider several equitable factors in making the decision whether to apply the contract default rate, including: creditor misconduct, harm to unsecured creditors, impairment of the debtor’s fresh start, whether the default rate is really a penalty, the parties’ course of dealing, and a comparison of the default rate to the non-default rate. It is in the application of these and other factors where the greatest divergence among courts lies. In parsing the cases not involving creditor misconduct, one trend emerges. Courts are more likely to disallow the default rate if there is a significant disparity between the default and nondefault rates and application of the default rate will significantly impact the return to general unsecured creditors or jeopardize the debtor’s successful reorganization.

Finally, if a chapter 11 debtor proposes to cure a loan default through a reorganization plan, what rate must it apply? The Bankruptcy Code specifies that the amount necessary to cure a default must be determined in accordance with the parties’ contract and applicable nonbankruptcy law. Most courts construing this requirement agree that the default rate should apply unless that rate is not permitted by the parties’ agreement or by applicable nonbankruptcy law.

In sum, lenders must analyze the particulars of each case in order to properly determine and maximize their claims for allowable pre or post-petition interest.

View on Website

These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create, and receipt of it does not constitute, an attorney-client relationship. Internet subscribers and online readers should not act upon this information without seeking professional counsel.