Real Estate Committee

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785 Partners LLC: The Rights of the Oversecured Creditor to Default Interest and Late Payment Premiums in a Solvent SARE Case

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Unlike many single-asset real estate cases in recent years, the debtor in the 785 Partners LLC chapter 11 case in the U.S. Bankruptcy Court for the Southern District of New York was solvent and the secured creditor was oversecured.[1] In this case, the amounts of the secured creditor's pre-petition claim and the post-petition allowance of interest under § 506(b) of the Bankruptcy Code are pivotal to the confirmation of the debtor's plan. In an opinion dated April 9, 2012, the court addressed the allowance of the default rate of interest and a late payment premium as part of the secured creditor's proof of claim, as well as the secured creditor's right to the allowance of post-petition interest at the default rate.

The lender had filed a secured proof of claim for $100,845,002.80 based on a principal balance of $81,212,506, with a reservation of the right to post-petition interest, legal fees and expenses. The debtor objected to the secured creditor's proof of claim. The court had already determined that the collateral, an apartment building at 48th Street and Eighth Avenue in New York had a value of $91.7 million and had assumed that the lender had a security interest in an escrow fund of $18 million. Since the lender's total collateral was $109.7 million, the lender was oversecured. The loan had matured and the debtor had been unable to pay the balloon payment due at maturity. In addition, the lender had made protective advances of more than $1 million.

The loan agreement provided that the debtor had an option to pay either an interest rate based on LIBOR (one-month LIBOR plus 2.75 percent per annum) or the *Wall Street Journal* prime plus 1.75 percent (the "base rate"). At the time the loan was made in 2007, the LIBOR rate and the base rate were equivalent; but at the time the petition was filed in August 2011, the base rate had risen to be about 2 percent higher than the LIBOR rate. Under the loan agreement upon default or maturity of the loan, the debtor no longer had an option available and the base rate applied. Further on maturity or default, the loan agreement provided that interest would accrue at a default rate calculated at the base rate plus 5 percent per annum. Since at all relevant times the base rate was 5 percent, the default rate was 10 percent. The loan documents also provided that the debtor was obligated to pay a late payment premium of 5 percent of any late payment that was due to the lender at the time of the debtor's late payment (the "late payment premium") "to cover the administrative and related expenses incurred in handling delinquent payments."[2] There was no exception in the loan documents for the late payment of the final balloon payment on maturity.

The lender's proof of claim included principal plus, among other things, the default rate interest and the late payment premium. The debtor objected to these portions of the proof of claim on the basis that both were unenforceable penalties, inequitable and unreasonable, and that the late payment premium was not permitted under the loan document's terms.

The court recognized that the rate for pre-petition interest allowance is an issue of applicable nonbankruptcy law. This loan was governed by New York law, which permitted a higher rate on default or maturity and did not permit judges to rewrite the parties' bargain, especially when they were sophisticated parties that were well counseled as in this case. Further, New York courts had found that a 5 percent increase in the interest rate on default was reasonable. Thus, the court declared that equitable consideration had no place under New York law.

Nevertheless, the debtor attempted to appeal to the court's equitable powers to disallow the default rate portion of the pre-petition claim and relied on *400 Walnut Assoc. LP v. 4th Walnut Assocs. LP (In re 400 Walnut Assocs. LP)*[3] for support. The court rejected the holding in *In re 400 Walnut Assocs. LP* as being wrongly based on equitable factors that were only appropriate for determining the proper post-petition interest rate to be allowed under § 506(b). Further, the court distinguished the holding in *400 Walnut* because it dealt with Pennsylvania law.[4]

The *400 Walnut* bankruptcy court was also asked to determine the amount of a secured lender's claim, including whether the secured lender was entitled to a pre-petition claim for default rate interest under the applicable promissory note. Contrary to the court's finding that *400 Walnut* dealt with Pennsylvania law, the debtor in *400 Walnut* did not rely on any nuance of Pennsylvania law to argue for the disallowance of the default rate for pre-petition interest. Rather, the debtor cited the opinion of the U.S. Bankruptcy Court for the Middle District of North Carolina in *Deep River Warehouse Inc.*[5] to the Eastern District of Pennsylvania bankruptcy judge as support for the use of equitable factors to disallow a pre-petition default rate provided for in the loan documents.[6]

Although the *Deep River* court stated that "whether interest will be allowed at the default rate is determined on a case-by-case basis and is fact specific,"[7] it determined that the only fact to be considered was state law and policy.[8] The North Carolina court further determined that the default rate under the contract should apply unless it was punitive, but noted that some courts had reviewed the default rate under other factors, such as whether: "(1) the creditor faces a significant risk that the debt will not be paid; (2) the lower rate of interest payable pre-default is shown not to be the prevailing market rate; (3) the difference between the default and the pre-default rates and whether the differential between the two rates are reasonable; and (4) whether the purpose of the higher interest rate is to compensate the creditor entitled to interest for losses sustained as a result of the fact that it was not paid at maturity or is simply a disguised attempt to penalize the debtor."[9]

Unfortunately, some courts, like *400 Walnut* and *In re Harvest Oaks Drive Associates LLC,*[10] have misread *Deep Water* as supporting the judicial application of equitable factors in determining whether to allow a pre-petition claim based on a default interest rate in the contract rather than merely applying applicable nonbankruptcy law (*i.e.*, state law and the parties' contract). Based on this reading, the *400 Walnut* court refused to enforce the contract default rate as required under Pennsylvania law based on that court's finding that the lender had bought the loan after default at a deep discount and that permitting the default interest would have been a windfall to the purchasing secured party.[11] Fortunately, the *Harvest Oaks* court did not find any fact that could support that court's equitable deviation from the contract default rate.[12]

In the instant case, the court not only refused to apply the holding in *400 Walnut* but also specifically rejected the debtor's entreat to follow the *400 Walnut* court's misguided consideration of the amount of the discount that the secured lender received when it purchased the loan from the original lender in deciding whether the pre-petition default rate should be allowed.[13]Instead, the court said that such a focus was improper and would require bankruptcy courts "to examine the circumstance of every assignment to determine the allowed amount of the claim in the hands of the assignee."[14]

Because the secured creditor's claim was oversecured by its collateral, the court then addressed the secured creditor's right to interest at the default interest rate on its secured claim under § 506(b). The court recognized that it had "limited discretion" to adjust the interest rate. While the Bankruptcy Code does not mandate the use of the contract rate of interest, there is a rebuttable presumption that the secured creditor is entitled to the contract default interest rate subject to adjustment on equitable considerations.[15] The burden of rebutting the presumption was on the debtor.

The court found that the debtor failed to prove the secured lender had engaged in misconduct that justified a deviation from the contract default rate. Further, the court stated that where the debtor is solvent, the reduction of the default rate post-petition was an inequitable and inappropriate windfall to the equity holders.[16] The court also rejected the debtor's argument that the default rate was a penalty based on the limited amount of actual expense and effort incurred after default by the secured creditor. The court rejected this argument on the basis that the appropriateness of the default rate should be measured at the time the contract was entered and the Debtor's evidence was "based on hindsight."[17] The court also found that the debtor had attempted to minimize the secured creditor's post-default risk since the secured lender had been compelled to make protective advances, which in essence was a forced additional loan with no new collateral.[18]

The debtor also attempted to claim its loss of the option to elect between the LIBOR rate and the base rate upon maturity was an additional 2 percent default interest penalty. The court rejected this argument as a mischaracterization of this provision of the loan agreement since this differential in rates was merely a function of the market changes and not intended by the parties to compensate the lender upon a default. It was just as likely the loss of the option could have been to the debtor's advantage, if it had elected the LIBOR rate and the base rate had been lower.[19]

Finally, the court reviewed the issue of whether the secured creditor was entitled to include the late payment premium in its pre-petition proof of claim and concluded that it was not. The right to the late payment premium under the contract was tied to the actual delinquent payment to the lender and was intended to cover the additional costs of handling the late payment.[20] The court reasoned that the debtor will never make the late payment under the loan agreement and that the lender will not incur the additional cost of handling the late payment since once the plan was confirmed the debtor's obligations under the loan agreement are replaced by those proved for under the plan. "Accordingly, the late payment charge will never become due and will never be earned."[21] Further, the court noted that cases were uniform in allowing the secured creditor "either default interest or late charges, but not both."[22] Interestingly, the *400 Walnut* court allowed the secured creditor to receive the late payment charge on the pre-acceleration late payments because the court had disallowed the default-interest claim.[23] However, being true to its application of equitable principals in allowing pre-petition claims, the *400 Walnut* court disallowed the late payment charge of more than $600,000 on the post-acceleration payment obligation of about $13 million as unreasonable.

The court ultimately determined that the secured lender was entitled to an allowed claim of $96,999,633.54 as of the petition date representing its principal, pre-petition interest at the default rate, its pre-petition protective advances and the administrative fee under the contract. The secured creditor was also entitled to allowance of its post-petition claim for protective advances and interest at the default rate on the principal balanced under §506(b). The court did not rule on allowance of the attorneys' fees claimed by the secured creditor, which it noted would be addressed in a separate opinion that does not appear on the docket at this time. The debtor's plan was confirmed on May 10, 2012.

1. *In re 785 Partners LLC*, 470 B.R. 126 (Bankr. S.D.N.Y. 2012).

2. *In re 785 Partners LLC*, 470 B.R. 126, 130 (Bankr. S.D.N.Y. 2012)

3. 461 B.R. 308 (Bankr. E.D. Pa. 2011) *rev'd and remanded* 2012 WL 2045728 (E.D.Pa. June 7, 2012)(Judge DuBois)(district court reversed the bankruptcy court's holding that the prepetition default interest could be disallowed under § 506(b) of the Code base on equitable factors and remanded for a determination of whether the original bank had waived the default interest for the period prior to the assignment to the new holder).

4. *Id.* at 133.

5. 2005 WL 1513123 (Bankr. M.D.N.C. 2005).

6. The *Deep River* court had also been requested to determine the secured lender's proof of claim including its right to a default interest under the note.

7. Citing *In re Dixon,* 228 B.R. 166, 173 (W.D. Va. 1998).

8. *Id* at *3.

9. *Id* at *3 & *4 (citations omitted).

10. 2011 WL 124495 (Bankr. E.D.N.C. 2011).

11. 461 B.R. at 316.

12. 2011 WL 124495 *8.

13. 470 B.R. at 133.

14. *Id.*

15. *Id.* at 134.

16. *Id.*

17. *Id.* at 135.

18. *Id.* at fn 6.

19. *Id.* at fn 7.

20. *Id.* at 136.

21. *Id.* at 137. (citations omitted).

22. *Id.*

23. 461 B.R. at 319.