The First Circuit Chooses a "Flexible" Approach to Post-Petition Interest

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May 15, 2014 - In a recent decision, the First Circuit used a "flexible" approach to value the collateral claimed by an oversecured creditor, and granted post-petition interest on the creditor's claim. *In re SW Boston Hotel Venture, LLC*, No. 12-9008, 2014 WL 1399418, — F.3d — (1st Cir. Apr. 11, 2014). Oversecured creditors (i.e., creditors whose collateral is worth more than the value of their secured claim) are exceptions to the general rule that creditors in a bankruptcy cannot receive post-petition interest. 11 U.S.C. § 502(b)(2) (disallowing claims for unmatured interest); 11 U.S.C. § 506(b) (creating exception for oversecured creditors). Considering the claim of a creditor who became oversecured during the bankruptcy proceeding, the First Circuit highlighted the extent of a court's discretion to determine how, when, and at what rate post-petition interest accrues. Choosing between two camps, the First Circuit adopted what is known as the "flexible" approach in establishing when the creditor became oversecured (the "valuation date") of the creditor's collateral, though the court noted that this approach might not be appropriate in other circumstances. The court looked to a pre-petition agreement among the parties to determine the rate at which post-petition interest accrued but found that, even though the parties' contract called for compounded interest, the creditor forfeited that particular right by not raising it in time.

Determining Secured Status: Application of the Flexible Approach

The parties in *SW Boston* did not dispute that the creditor, Prudential Insurance Company of America ("Prudential"), became oversecured at some point during the bankruptcy proceeding, but they disagreed as to when this occurred. Because Prudential's claim decreased over the course of the proceeding while the value of its underlying collateral increased, the measuring date made "the difference between a finding of oversecurity or undersecurity." *In re SW Boston Hotel Venture, LLC*, No. 12-9008, 2014 WL 1399418, at *6 (1st Cir. Apr. 11, 2014).

The Bankruptcy Code does not indicate when a court should value secured collateral to determine a creditor's secured status. The case law has separated into two camps: some courts have adopted a strict "single-valuation" approach, where creditors' secured statuses are categorically determined on the same date, such as the filing date

or plan confirmation date. *See, e.g., Orix Credit Alliance, Inc. v. Delta Res., Inc.*, 54 F.3d 722, 729 (11th Cir. 1995). Other courts endorse a "flexible" approach, whereby the bankruptcy court chooses the valuation measuring date based on each case's circumstances. S*ee, e.g., In re T-H New Orleans Ltd. P'ship*, 116 F.3d (5th Cir. 1997).

In *SW Boston*, the First Circuit applied the flexible approach, finding that section 506(b), the bankruptcy rules, and the legislative history's silence on the matter "[suggest] flexibility." *SW Boston*, 2014 WL 1399418, at *8. The measuring date expressly provided by Congress in section 506(a) implies that the valuation contemplated by section 506(b) was not limited to a particular date.[1] The flexible approach also appealed to the Court's consideration of fairness and equity, avoiding "an all-or-nothing result that hinges more on fortuity than reality" and seeming "more likely to produce fair outcomes." *Id.* at *9. While under the single-valuation approach, a creditor who becomes oversecured a day after the chosen date is not entitled to receive post-petition interest and a creditor who becomes oversecured a day earlier is. The court clarified that it did "not suggest that bankruptcy courts must, or even should, adopt the flexible approach whenever collateral values and/or claim amounts fluctuate," but instead "simply recognize[s]" that a bankruptcy court may look to principles of equity and fairness in determining the best approach. *Id.* at *10, n.13.

<u>A Note on the Valuation of Collateral</u>

The bankruptcy court considered several potential valuation dates, including the petition date. Prudential asserted that it was oversecured on the petition date, pointing solely to the debtors' asset schedules as proof.[2] The bankruptcy court instead applied the property's sale price and closing date to determine oversecurity. In finding that the bankruptcy court did not err in this determination, the First Circuit held "that a valuation made for one purpose at one point in a bankruptcy proceeding has no binding effect on valuations performed for other purposes at other points in the proceeding." *Id.* at *11.

<u>Simple Interest Accruing at a Contractually Determined Rate</u>

Section 506(b) does not determine at what rate post-petition interest accrues and whether it does so as simple or compounded interest. Courts generally agree that the appropriate interest rate is within the court's discretion. But where an interest rate has been contractually agreed upon by the parties, such terms "presumptively apply" if they are not invalid under state law or inequitable. *Id.* at *13. The First Circuit approved of the lower courts' use of a default rate specified in the loan agreement between the debtor and Prudential. It found that the debtor failed to show that the default rate exceeded the threshold established by applicable state law, that the default rate was lawful under state law, and that the rate did not violate federal equitable principles.

The court also considered and rejected Prudential's argument that its post-petition interest compounded on a monthly basis. Although the parties' agreement expressly called for monthly compounding of interest, the Court found that the creditor forfeited its "entitlement to compounding where it . . . did not seek compound interest until after the bankruptcy court granted it post-petition interest…" *Id.* at *15.

<u>Practical Implications</u>

In lieu of clear guidelines, the First Circuit's decision elevates flexibility and fairness over other potential factors. Under *SW Boston*, potential creditors cannot anticipate which valuation approach will apply to their circumstances, or how the court will apply its discretion. But potential creditors can take steps to protect themselves. Parties should draft clear agreements with a view to potential bankruptcy, keeping in mind that the default rates they choose may be applied to post-petition interest. Once proceedings have commenced, it is in a creditor's best interest to seek oversecured status early on, to seek the valuation of underlying property in the proper context, and to support any related claims with ample evidence.

Footnotes

[1]. The Court stated that "[t]he fact that Congress mandated particular measuring dates in the exception without mandating a particular measuring date in the general rule suggests that it intended flexibility . . . ." *Id.* at *8.

[2]. The Debtors' schedules of assets "indicated that the value of Prudential's collateral, in the aggregate, was substantially more than its total pre-petition claim." *Id.* at *10.

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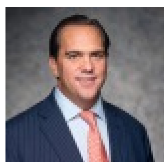

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