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Bankruptcy, Restructuring & Commercial Law Advisory

Equity Begets Flexibility: Valuing a Secured Creditor's Claim in Bankruptcy and Allocating Post-Petition Interest

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BY ERIC R. BLYTHE AND KEVIN J. WALSH

Kevin J. Walsh, *Member*

Eric R. Blythe, *Associate*

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The First Circuit Court of Appeals in *In re SW Boston Hotel Venture, LLC*, 2014 U.S. App. LEXIS 6768 (1st Cir. Apr. 11, 2014) recently ruled on a number of issues critical to valuing a secured claim in bankruptcy. Specifically, the court 1) endorsed the use of a "flexible approach" to value collateral under the circumstances of this case, 2) recognized that the date collateral should be valued is the lender's burden to prove, and 3) confirmed that the pre-petition agreement's default interest rate should generally be used to determine the post-petition interest rate. This case is of particular relevance to secured creditors that may be (or become) oversecured during a bankruptcy case.

In general, the Bankruptcy Code permits a secured creditor to receive unmatured interest on its claim during a bankruptcy case if and to the extent the claim is oversecured, i.e., that the value of the collateral securing the claim exceeds the amount of the claim. However, determining the amount of unmatured, post-petition interest can be complicated when the value of the collateral changes over the life of the case. Indeed, in *SW Boston*, the parties agreed that the secured creditor was oversecured for at least part of the bankruptcy proceeding and that the creditor was entitled to some amount of post-petition interest. Yet, the parties disagreed on how to determine oversecured status, when the creditor became oversecured and how to calculate the appropriate amount of interest.

Background

SW Boston Hotel Venture, LLC ("SW Boston") developed a mixed-use property that would become the W Hotel (the "Hotel") and Residences (the "Condos") in Boston. SW Boston financed the project through the Prudential Insurance Company of America ("Prudential"), and Prudential received a mortgage and first priority security interest in SW Boston's real and personal property, including the Hotel and Condos (collectively, the "SW Boston Collateral"). SW Boston completed the construction of the Hotel and Condos in October of 2009, but purchases and occupancy rates were lower than expected. Additionally, a number of the Hotel and Condo amenities – the restaurant, spa and bar – remained incomplete. In December 2009, the City of Boston (the "City") provided additional funding to permit SW Boston to finish constructing the amenities; the City was secured by a junior lien on most of the collateral that secured the Prudential loan. Despite the additional funding, on April 28, 2010, SW Boston and four affiliated entities filed Chapter 11 bankruptcy petitions, which were followed on June 4 by three additional affiliated entities (collectively, the "Debtors").

Four months into the bankruptcy case, Prudential filed a motion for relief from the automatic stay arguing that it lacked adequate protection (i.e., was undersecured) because the amount of its claim exceeded the value of the SW Boston Collateral (Prudential's claim was approximately $154 million, exclusive of any post-petition interest or expenses). After a three-day hearing, the bankruptcy court found that Prudential was undersecured with respect to the Hotel and Condos (valued collectively at $153.6 million), but oversecured by an amount in excess of $19 million when accounting for Prudential's entire collateral package, which included assets of the affiliated debtors as well. Accordingly, the court ruled that Prudential was adequately protected, and denied the lift-stay motion.

On May 24, 2011, the bankruptcy court approved the Debtors' motion to sell the Hotel for $89.5 million. The proposed sale had several significant contingences to closing. Three days after approval of the Hotel sale motion, the Debtors filed their reorganization plan. The plan called for Prudential to be paid in full by March 2014 if the hotel sale closed, or after a more extended period if it did not. The plan further provided that

Prudential would receive interest of 4.25% per annum after the plan became effective, but it made no provision for post-petition interest during the case and prior to the effective date of the plan. Prudential objected to the plan on multiple grounds. Relevant for this advisory, ten months after it had moved for relief from the stay by arguing it had an undersecured claim, Prudential moved for a determination that it was oversecured and therefore entitled to post-petition interest.

Flexible Valuation Approach

To address Prudential's claim that it was oversecured, the First Circuit first considered whether to apply a flexible or single-valuation approach in determining the value of Prudential's collateral. Acknowledging a circuit split on this issue, the court examined the two potential valuation methods. The "single-valuation" approach involves a determination of oversecured status at a fixed point in time (generally either the petition date or the confirmation date). The "flexible" approach allows the bankruptcy court discretion to determine the appropriate measuring date based on the circumstances of the case.

In this case, both the bankruptcy court and the bankruptcy appellate panel ("BAP") had adopted the flexible approach, though their respective applications of the approach differed. The First Circuit agreed with the lower courts stating that "[t]he availability of a flexible approach strikes us as more likely to produce fair outcomes than allowing post-petition interest for the entire bankruptcy, or not at all, based on a rigidly defined one-shot vantage point." However, the First Circuit refrained from mandating the flexible approach holding that, "*at least in the circumstances presented here*, a bankruptcy court *may*, *in its discretion*, adopt a flexible approach." (emphasis added).

Date of Determination

The First Circuit then evaluated the appropriate measuring date, along the continuum of the petition date to the confirmation date, for determining oversecured status. The bankruptcy court had found that the Hotel sale price provided the best evidence of the Hotel's value as of the sale date. However, given the significant contingencies in the sale agreement, the bankruptcy court concluded that the sale price was not reflective of the Hotel's value at any earlier time in the case. The BAP agreed that the sale price was the best evidence of value, but concluded that the sale price established that Prudential was oversecured throughout the pendency of the bankruptcy proceedings.

The First Circuit noted that the burden of proof was on Prudential to establish when it became oversecured under the flexible approach. Prudential unsuccessfully argued that earlier valuations (e.g., in the Debtors' schedules, or through prior adequate protection determinations) showed Prudential to be oversecured. Noting the valuation determinations that occurred during Prudential's lift-stay motion, the First Circuit explained that earlier valuations for one purpose do not bind courts with regard to later valuations for some other purpose. In fact, the changing scenarios (Prudential's declining claim as additional condos were sold, the Hotel and Condos' increasing value as improvements were made) throughout the bankruptcy case showed these earlier valuations to be of questionable use. While the First Circuit noted that it was plausible that Prudential's declining claim and the SW Boston Collateral's increasing value may have crossed paths at some point before the Hotel sale date, Prudential had not carried its burden of proof in demonstrating that it was oversecured at any prior date. Thus, the First Circuit upheld the sale date as the date from which post-petition interest should accrue.

Computation of Interest

Finally, the First Circuit examined the type and rate of post-petition interest applicable to Prudential's oversecured claim. To calculate post-petition interest rates, courts generally agree that where parties have contractually stated interest terms, those terms should presumptively apply so long as they are enforceable under state law, and equitable considerations do not dictate otherwise. The bankruptcy court and the BAP both held that Prudential was entitled to interest at 14.5% – the default rate specified in the parties' agreement. The First Circuit noted that it was the Debtors' burden of proof to rebut the presumption in favor of enforcing the contractual rate, and concluded that the Debtors failed to show that the default rate was grossly disproportionate to anticipated damages or otherwise unconscionable as to be unenforceable under Massachusetts law. Therefore the 14.5% rate applied.

As to whether interest should be calculated as simple or compounding, the First Circuit explained that compound interest is disfavored under Massachusetts law, and is generally not applicable absent an express agreement to the contrary. The parties' agreement in this case defined "Applicable Interest Rate" as "9.50% per annum, *compounding* monthly," (emphasis added) and the "Default Rate" as "a rate per annum equal to the lesser of (i) the maximum rate permitted by applicable law, or (ii) five percent (5%) above the Applicable Interest Rate." The courts found the language of the agreement was unclear as to whether compound interest applied to the Default Rate. Importantly, Prudential failed to raise the issue at trial. Prudential only sought compound interest after the bankruptcy court ruled on the appropriate interest rate.

Upon review of the issue, the First Circuit was troubled by the fact that Prudential, "whether by inadvertence or in an attempt to sandbag the Debtors and mislead the bankruptcy court[,]" did not seek compound interest until after the bankruptcy court granted Prudential post-petition interest at the default rate. Accordingly, the First Circuit ruled that "[w]e do not believe that Prudential, having failed to give the bankruptcy court the opportunity to consider whether application of compound interest (even if the contract calls for it) would have been equitable, can now be heard to complain that the court abused its discretion (or even erred) in disallowing compounding." Accordingly, and without deciding the issue on its merits, the First Circuit ruled that Prudential was not entitled to compound interest.

Conclusion

The First Circuit recognized equitable considerations in affirming use of the flexible approach in determining whether a claim is oversecured, leaving the issue to the discretion of the bankruptcy court but not mandating the approach as the only one available in the First Circuit. The court did not break from precedent when affirming the use of the contractually agreed default rate of interest as the applicable rate for post-petition interest. And, in the face of ambiguity, the court followed applicable nonbankruptcy law in determining that simple, rather than compound, interest would apply post-petition.

Secured lenders involved in bankruptcy cases must remain vigilant and diligently pursue their rights or risk losing them. Such lenders must be prepared to carry the burden of proof at all times when asserting a claim for post-petition interest, as any interest paid to a secured creditor means less cash available to pay to unsecured creditors. The lender needs to be prepared to prove the amount of the claim, the value of the collateral, the time when the value of the collateral should be determined and finally, if the claim is demonstrated to be oversecured, the amount and type of interest that should be applied to the claim.

If you have any questions about this decision or its implications, please call your principal Mintz Levin attorney or one of the attorneys noted on this advisory.