

Influential Bankruptcy Court Awards Oversecured Creditor Postpetition Interest at the Default Rate, Even Where the Debtor Is Insolvent

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In *In re Residential Capital, LLC*, the U.S. Bankruptcy Court for the Southern District of New York recently granted an oversecured creditor's request for postpetition interest at the contractual default rate, even though the debtor was insolvent. In doing so, the Bankruptcy Court rejected an argument that awarding postpetition interest at the default rate (which was 4% higher than the non-default rate) would provide an undue windfall to the oversecured creditor and harm unsecured creditors.

Why This Decision Is Important

This decision, from a jurisdiction in which many large commercial bankruptcy cases are filed, is instructive because it expressly declined to establish a bright-line rule that would deny postpetition interest at the default rate if the debtor is insolvent. This decision also provides useful guidance regarding the factors courts may consider in determining whether the "balance of the equities" weighs against awarding postpetition interest to oversecured creditors at the default rate. For example, courts may be more likely to award postpetition interest at the default rate if:

- the debtor is solvent or relatively close to being solvent,
- the award of default-rate interest would not result in a very significant reduction in the unsecured creditor recovery percentage,
- the pre-petition financing helped enable the debtor to continue operating as a going concern during the bankruptcy case, or
- other events of default had occurred under the credit agreement in addition to the bankruptcy filing.

Background

Before Residential Capital, LLC (ResCap) and certain of its affiliates commenced their chapter 11

proceedings on May 14, 2012, Citibank entered into a \$700 million secured revolving credit facility with GMAC Mortgage LLC as borrower and ResCap as guarantor.

The parties subsequently amended the credit agreement 10 times, with the final amendment extending the maturity date to May 30, 2012. The parties entered into the 10th amendment with the express understanding that ResCap would file a voluntary bankruptcy petition very shortly thereafter. Indeed, ResCap filed its chapter 11 case 16 days before the credit facility matured. The bankruptcy filing constituted an event of default under the credit agreement. Further, ResCap did not repay the balance of the loan on the May 30, 2012 maturity date, which resulted in a second event of default.

Citibank later moved the Bankruptcy Court for an order directing ResCap to pay the difference between the interest that had accrued at the default rate and the non-default interest that ResCap had already paid. Citibank also requested reimbursement of its legal fees and expenses, which ResCap had stopped paying.

The Bankruptcy Court's Decision

Section 506(b) of the Bankruptcy Code provides that an oversecured creditor (i.e., a creditor whose claim is secured by collateral of a value that is greater than the amount of the claim) is entitled to "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose."

Although Section 506(b) does not specify the *rate* of postpetition interest to which oversecured creditors are entitled, there is a rebuttable presumption that postpetition interest is allowed at the rate specified in the contract between the debtor and the oversecured creditor. However, courts may apply a different interest rate if the "balance of the equities" favors doing so. For example, a court may find that the balance of the equities does not favor the imposition of the contractual default rate where (a) the secured creditor engaged in misconduct, (b) unsecured creditors would be harmed or the debtor's fresh start would be impaired or (c) the rate constitutes an impermissible "penalty."

In this case, the liquidating trust argued that the imposition of that rate would harm unsecured creditors because ResCap was insolvent, as unsecured creditors were to receive distributions of only 9% to 36% under ResCap's confirmed chapter 11 plan. Thus, any additional dollars going to Citibank would come from the pockets of the unsecured creditors, who already stood to recover only a portion of their claims.

The Bankruptcy Court stated that the issue of whether a debtor is insolvent "is certainly an important factor courts consider in deciding whether to award an oversecured creditor postpetition interest at the contract default rate. But no court has adopted a bright-line rule that the contract default rate should be refused in all insolvent debtor cases." Indeed, the Bankruptcy Court noted that most chapter 11 cases involve insolvent debtors, and such an exception would swallow the rule that the oversecured creditor is presumptively entitled to postpetition interest at the default rate. On the other hand, the Bankruptcy Court stated that "[i]n many or even most cases involving insolvent debtors, the balance may well fall on the side of the junior secured or unsecured creditors—they are the ones that will have their distributions reduced when the oversecured creditor is awarded postpetition interest at the contract default rate."

Having refused to invoke a categorical rule denying postpetition interest at the default rate if the debtor is insolvent, the Bankruptcy Court examined whether the "balance of the equities" as a whole favored awarding Citibank only the non-default rate in this case. Although it characterized the issue

as "a close one here," the Bankruptcy Court concluded that the harm to unsecured creditors of awarding Citibank postpetition interest at the default rate did not overcome the rebuttable presumption favoring the use of the default rate. In so concluding, the Bankruptcy Court noted the following facts in this particular case:

- The \$5 million additional interest that would be paid to Citibank if the default rate imposed would diminish the pool of assets distributable to unsecured creditors by only 0.2%. The Bankruptcy Court found that a reduction of that magnitude was not, on its own, sufficient to overcome the presumption in favor of awarding the default rate.
- The 10th amendment to the credit agreement was one piece of ResCap's complex, multi-layered postpetition financing arrangement, which enabled ResCap to continue operating during the bankruptcy case as a going concern. All creditors benefited from ResCap's operation as a going concern in bankruptcy, as it was able to sell its main businesses during that time, with the proceeds going to pay its secured and unsecured creditors.
- If Citibank had thought that it would not be entitled to postpetition interest at the default rate, it could have demanded a higher non-default rate while negotiating the 10th amendment. The Bankruptcy Court found that the potential adverse effect on the terms and availability of credit for high-risk borrowers, particularly when credit terms are negotiated in contemplation of a bankruptcy filing (like the 10th amendment was), was a factor supporting the application of the default rate here.
- In opposing Citibank's request for interest at the default rate, the liquidating trust noted that (a) Citibank received timely interest payments at the non-default rate, (b) repayment of principal was never seriously at risk because of the stalking horse bids that ResCap received for its assets before the bankruptcy filing and (c) ResCap had already repaid \$124 million of the loan before the bankruptcy filing. The Bankruptcy Court stated that even though all of those facts were true, Citibank still negotiated for the default rate in light of the risks it accepted by extending the maturity of the loan.

The Bankruptcy Court declined to award postpetition interest at the default rate for the 16 days between ResCap's May 14 bankruptcy filing date and the May 30 maturity date of the loan, because ResCap had been current on the loan and the only event of default that had occurred before the maturity date was the filing of the bankruptcy case.

Having found that Citibank was entitled to recover postpetition interest at the default rate after May 30, the Bankruptcy Court "easily" concluded that Citibank should also be awarded its legal fees. Interestingly, the Bankruptcy Court stated that even if it had ruled *against* Citibank with respect to default-rate interest, it still would have awarded Citibank its legal fees because it pursued its request in good faith.

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