SECTION 506—SECURED CREDITORS' CLAIMS

Nancy A. Peterman and Rebecca D. Rosenthal[*]

Section 506 of the Bankruptcy Code establishes the amount and value of secured claims against a debtor's estate. Pursuant to section 506(a), the dollar amount of a secured claim cannot exceed the value of the debtor's interest in the property securing the claim. Thus, the secured claim amount is limited to the lesser of: (i) the allowed amount of the claim or (ii) the value of the debtor's interest in the collateral. If the amount of the allowed claim is less than the value of the collateral, then the claim is "oversecured." If the amount of the allowed claim exceeds the value of the collateral, then the claim is "undersecured." "Undersecured" claims are bifurcated into a secured claim (equal to the value of the debtor's interest in the collateral) and an unsecured claim (equal to the amount by which the creditor's claim exceeds the value of the debtor's interest in the collateral). Section 506(a) was amended as of October 17, 2005 to provide more specific direction on the method and timing for valuing certain types of collateral in certain cases.

Section 506(b) permits a creditor holding an allowed oversecured claim to include, as part of that secured claim, any interest, costs and other charges allowed under its agreement with the debtor, including, without limitation, attorneys' fees and expenses. Section 506(b) was also amended in 2005 to provide that interest, fees, costs and charges allowed under a state statute also are allowed as part of a claim under section 506(b).

While subsection (b) allows a creditor to increase the amount of its secured claim in certain instances, section 506(c) allows the trustee or debtor-in-possession to potentially decrease the amount of a secured claim by "surcharging" the creditor's collateral with the reasonable, necessary costs and expenses of preserving or disposing of the collateral. The amount of the surcharge is limited to the benefit conferred upon the secured creditor. Therefore, while the creditor's claim may be decreased by a surcharge, in theory, the surcharge merely avoids the unjust enrichment to the creditor or its collateral at the estate's expense. Section 506(c)

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[*]Nancy Peterman and Rebecca Rosenthal are attorneys at Greenberg Traurig, LLP, 77 West Wacker Drive, Suite 3100, Chicago, IL 60601, petermann@gtlaw.com and rosenthalr@gtlaw.com.

was amended, as part of the 2005 amendments to the Bankruptcy Code, to provide that payment of ad valorem property taxes with respect to the collateral also may be surcharged against the creditor's collateral.

Section 506(d) addresses the continuing validity of a secured creditor's lien once the debtor files for bankruptcy protection. Under section 506(d), if a secured claim is "not an allowed secured claim," then the lien is void unless one of two exceptions applies. Under section 506(d), a lien is not void if (i) the underlying claim is disallowed under either section 502(b)(5) or 502(e)[1] of the Bankruptcy Code or (ii) such claim is not an allowed secured claim due to the failure of an entity to file a proof of such claim under section 501 of the Bankruptcy Code.

I. CAN THE INTEREST RATE UNDER SECTION 506(b) BE THE DEFAULT RATE?

While section 506(b) permits the inclusion of postpetition interest when a secured creditor's claim is oversecured, neither the Bankruptcy Code nor the Bankruptcy Rules provide guidance regarding the appropriate rate of interest. Section 506(b) provides that an oversecured creditor 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."[2] Therefore, a secured creditor may include interest in its claim at the contractual rate of default interest, as such rate is typically higher than the predefault rate of interest.

The United States Supreme Court has addressed the issue of whether postpetition interest may be included in a secured creditor's claim, but merely held that an award of "fees, costs, or charges" is dictated by the loan agreement, without any further

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[1] Under section 502(b)(5), a court shall determine the amount of a claim except to the extent that the claim is for a debt that is unmatured as of the petition date and excepted from discharge under section 523(a)(5). Under section 502(e)(1), a court shall disallow for reimbursement or contribution any claim of any entity that is liable with the debtor on or has secured the claim of a creditor to the extent that (a) such creditor's claim against the estate is disallowed, (b) such claim for reimbursement or contribution is contingent at the time of allowance/disallowance of such claim for reimbursement or contribution, or (c) such entity asserts a right of subrogation to the rights of such creditor under section 509. Under section 502(d)(2), a claim for reimbursement or contribution of such an entity that becomes fixed after the petition date is treated for allowance/disallowance as if it became fixed before the petition date.

[2] 11 U.S.C.A. 506(b).

clarification.[3] As a consequence, lower courts are divided as to whether the contractual rate of default interest is binding or whether courts may examine the reasonableness of the contractual rate of default interest and modify such interest based on the equities.[4]

a. Is the Default Rate of Interest Even Applicable?

Before determining whether the contractual rate of default interest is properly added to a secured claim, as a threshold matter, the court must first determine whether the default rate of interest can be charged. Courts have found that if the underlying contract between a debtor and secured creditor contains language stating that acceleration was at the option of the secured creditor and such option was not properly exercised prepetition, then the creditor cannot charge the default rate of interest.[5]

For example, in *In re Potts,*[6] the court analyzed the following contractual language:[7]

> If any payment required by this Note is not paid when due, or if any default under any Deed of Trust securing this Note occurs, the entire principal amount outstanding and accrued interest thereon shall at once become due and payable at the option of the Note Holder (Acceleration); and the indebtedness shall bear interest at the rate of 12% per annum from the date of default.

The *Potts* court interpreted the above language as requiring the creditor to take affirmative action to accelerate the debt (at its option). If the creditor exercised the option of accelerating the debt and took affirmative action to do so, then the default rate of interest would be triggered under the contract.[8] The *Potts* court distinguished the contract at issue from those contracts whereby acceleration is automatic and, therefore, the imposition of default

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[3] *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 18 Bankr. Ct. Dec. (CRR) 1150, Bankr. L. Rep. (CCH) P 72575, 89-1 U.S. Tax Cas. (CCH) P 9179, 63 A.F.T.R.2d 89-652 (1989).

[4] *See* 4 Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy ¶ 506. 04[2][b][ii] at 506–104 (16th rev. ed. 2013).

[5] *In re Potts*, 2013 WL 5508429, *7 (Bankr. D. Colo. 2013); *see also In re Payless Cashways, Inc.*, 287 B.R. 482 (Bankr. W.D. Mo. 2002); *In re Tarkio College*, 195 B.R. 424, 29 Bankr. Ct. Dec. (CRR) 36, 109 Ed. Law Rep. 259 (Bankr. W.D. Mo. 1996).

[6] Potts, 2013 WL 5508429 at *6.

[7] Potts, 2013 WL 5508429 at *6.

[8] Potts, 2013 WL 5508429 at *7.

interest is automatic.[9]

b. Is the Contractual Rate of Default Interest Binding or Can Courts Examine the Rate's Reasonableness?

Some courts have found that the contractual rate of default interest is binding upon the debtor because a default interest rate, like other interest rates in a contract, should be the subject of negotiation at the time a contract is negotiated and signed. In addition, by including such a rate in a contract, the parties have given their assent to a contractual default interest rate.[10] Other courts, however, have held that default interest rates should be treated like late charges and examined for reasonableness.[11]

In analyzing the reasonableness of the default rate of interest, generally, there is a presumption in favor of the contractual rate of default interest, subject to rebuttal based upon equitable considerations.[12] Some courts have held that a court's power to modify the contractual rate of default interest based on notions of equity should be exercised sparingly and limited to situations where (a) the secured creditor is guilty of misconduct, (b) the application of the contractual interest rate would harm the unsecured creditors or impair the debtor's fresh start, or (c) the contractual interest rate constitutes a penalty.[13] Other courts have rebutted the presumption in favor of the contractual rate of default interest in situations where the contractual rate was significantly higher than the predefault rate of interest, without the secured creditor providing any justification for such

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[9]*See In re PCH Associates*, 122 B.R. 181 (Bankr. S.D. N.Y. 1990).

[10]*In re Skyler Ridge*, 80 B.R. 500, 511, 16 Bankr. Ct. Dec. (CRR) 1122, Bankr. L. Rep. (CCH) P 72167 (Bankr. C.D. Cal. 1987); *see also In re Courtland Estates Corp.*, 144 B.R. 5, 10, 23 Bankr. Ct. Dec. (CRR) 624 (Bankr. D. Mass. 1992); *Matter of Martindale*, 125 B.R. 32, 37 (Bankr. D. Idaho 1991).

[11]*In re AE Hotel Venture*, 321 B.R. 209, 215, 44 Bankr. Ct. Dec. (CRR) 92 (Bankr. N.D. Ill. 2005); *see also In re Consolidated Properties Ltd. Partnership*, 152 B.R. 452, 456 (Bankr. D. Md. 1993).

[12]*Matter of Terry Ltd. Partnership*, 27 F.3d 241, 243, 31 Collier Bankr. Cas. 2d (MB) 231, Bankr. L. Rep. (CCH) P 75933 (7th Cir. 1994).

[13]*In re 785 Partners LLC*, 470 B.R. 126, 134, 56 Bankr. Ct. Dec. (CRR) 83 (Bankr. S.D. N.Y. 2012); *see also In re General Growth Properties, Inc.*, 451 B.R. 323, 328, 55 Bankr. Ct. Dec. (CRR) 6, 65 Collier Bankr. Cas. 2d (MB) 1351 (Bankr. S.D. N.Y. 2011); *Urban Communicators PCS Ltd. Partnership v. Gabriel Capital, L.P.*, 394 B.R. 325, 338 (S.D. N.Y. 2008); *In re P.G. Realty Co.*, 220 B.R. 773, 780, 32 Bankr. Ct. Dec. (CRR) 718 (Bankr. E.D. N.Y. 1998).

difference.[14] Once the presumption in favor of the contractual rate of default interest is rebutted, the burden shifts to the secured creditor to demonstrate that the contractual default rate is reasonable.[15]

Recently, in *In re Haldes*,[16] the bankruptcy court addressed the issue of whether to award the contractual rate of default interest. In this case, the secured creditor was requesting a default interest rate of 16.25%, as compared to the predefault interest rate of 6.25%.[17] The court stated that the default interest rate of 16.25% represented a 160% increase over the predefault rate.[18] In addition, the creditor claimed late charges of approximately $85,000 and attorney's fees in excess of $74,000.[19] During testimony, the creditor presented evidence that the interest rate of 16.25% was within the range of default rates charged in the commercial lending market during the relevant time period.[20] However, the creditor provided no evidence with respect to the residential lending market. The loan at issue was a construction loan on a single-family residence that was later packaged with commercial property.[21] In its reasoning, the *Haldes* court stated that it was:[22]

> hard-pressed to conclude that the 16.25% percent figure represents a reasonable forecast of damages. The 10 percent "Default Rate Margin" is simply too high. It is not a reasonable charge because it compensates for an injury that has already been substantially compensated for in some other way under the Note, namely, through late charges and attorney's fees.

The *Haldes* court also held that "it would be inequitable to award no default interest" to the creditor because the debtor is solvent, the plan proposes to pay all allowed unsecured claims in full and the debtor stands to receive the proceeds from the sale of the property.[23] The *Haldes* court held that a 10.25% rate of default

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[14]Terry Ltd. P'ship, 27 F.3d at 243*; see also* Consol. Props. Ltd. P'ship. 152 B.R. at 453.

[15]*In re Haldes*, 503 B.R. 441, 446 (Bankr. N.D. Ill. 2013).

[16]Haldes, 503 B.R. at 446.

[17]Haldes, 503 B.R. at 446.

[18]Haldes, 503 B.R. at 446.

[19]Haldes, 503 B.R. at 446.

[20]Haldes, 503 B.R. at 446.

[21]Haldes, 503 B.R. at 446.

[22]Haldes, 503 B.R. at 447.

[23]Haldes, 503 B.R. at 447.

interest was reasonable under the circumstances.[24]

II. MULTI-DEBTOR CASES

Two recent cases spotlight another aspect of section 506(b). These two cases, *In re Revolution Dairy LLC*[25] and *In re Residential Capital LLC,*[26] involve multiple debtors and consider whether collateral values should be measured on an aggregate basis across all debtors or on an individual basis for each separate debtor when determining whether a secured lender is oversecured.

a. In re Revolution Dairy LLC

On January 27, 2013, three dairy farms filed Chapter 11 bankruptcy cases, which cases were subsequently jointly administered.[27] One of the debtors' secured lenders, Rabo Agrifinance, Inc. ("Rabo"), had a first lien on all of the debtors' personal property except milk proceeds and a second lien on the debtors' milk proceeds and real property.[28] Another secured lender, Metropolitan Life Insurance Company ("Met Life"), had a first lien on the debtors' milk proceeds and a second lien on all other personal property.[29] In connection with the court's cash collateral hearing, the parties agreed that "if the Court views the Debtors' property as a pool of collateral securing Met Life's and Rabo's debt, then the value of the collateral exceeds Met Life's and Rabo's claims."[30] However, the court also stated that "if each Debtor is considered separately, the combined amount of Rabo's and Met Life's debt exceeds the value of the collateral owned by each Debtor by a significant amount. In other words, there is no equity cushion."[31]

The debtors' argued that the secured creditors were adequately protected because the debtors' aggregate collateral value provided

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[24]Haldes, 503 B.R. at 447.

[25]In re Revolution Dairy LLC, et al., No 13-20770 (Bankr. D. Utah April 29, 2013), Hr'g Tr. [Dkt. No. 206].

[26]*In re Residential Capital, LLC*, 501 B.R. 549 (Bankr. S.D. N.Y. 2013).

[27]In re Revolution Dairy LLC, No. 13-20770 (Bankr. D. Utah); In re Highline Dairy, LLC, No. 13-20771 (Bankr. D. Utah); and In re Robert and Judith Bliss, dba Bliss Dairy, No. 13-207732 (Bankr. D. Utah).

[28]Revolution Dairy, Hr'g Tr. at 6.

[29]Revolution Dairy, Hr'g Tr. at 6.

[30]Revolution Dairy, Hr'g Tr. at 7.

[31]Revolution Dairy, Hr'g Tr. at 8.

a sufficient equity cushion to the secured creditors.[32] At the same time, the debtors also argued that if each debtor was valued individually, the secured creditors were undersecured and, therefore, not entitled to receive postpetition interest and attorney's fees under section 506(b) of the Bankruptcy Code.[33] As summarized by the *Revolution Dairy* court:[34]

> The Debtors contend that their argument that the equity cushion they identify may be used to provide adequate protection, but is not available to pay Met Life's and Rabo's post-petition interest and attorney's fees, does not conflict with the [C]ode's directive that secured creditors are to receive the indubitable equivalent of their claims. The Debtors argue that this is a simple determination because, if the Debtors are viewed individually, Met Life and Rabo are under-secured creditors under 506(a), and therefore 506(b) precludes them from receiving post-petition interest and attorney's fees.

The *Revolution Dairy* court found the debtors' argument without merit because it is "clearly inconsistent with the [C]ode and cannot stand modest scrutiny."[35] Moreover, the court stated that the issue of whether the collateral should be valued on an aggregate basis or on an individual basis for each debtor was one of allocation and that "until Debtors allocate these claims, or propose some method of ensuring Met Life and Rabo will receive the indubitable equivalent of their interest, Met Life and Rabo are entitled to be paid the full value of all the collateral in each estate."[36] Finally, in its discussion regarding allocation, the *Revolution Dairy* court reasoned that irrespective of whether the bankruptcy estates were substantively consolidated or whether the debtors elected to allocate the secured creditors' claims among each debtor entity, in the end, the secured creditors would be oversecured.[37]

b. In re Residential Capital LLC

In *Residential Capital*, the creditors' committee and debtors proposed a plan of reorganization which treated secured bond-

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[32]Revolution Dairy, Hr'g Tr. at 9.

[33]Revolution Dairy, Hr'g Tr. at 12.

[34]Revolution Dairy, Hr'g Tr. at 12.

[35]Revolution Dairy, Hr'g Tr. at 13.

[36]Revolution Dairy, Hr'g Tr. at 13.

[37]Revolution Dairy, Hr'g Tr. at 18.

holders as undersecured.[38] Certain secured bondholders voted against the plan contending that they were oversecured and entitled to postpetition interest and fees under section 506(b) of the Bankruptcy Code.[39] The creditors' committee and debtors filed separate adversary proceedings challenging the liens and claims of certain secured bondholders.[40] These adversary proceedings were subsequently consolidated.[41] The debtors and the creditors' committee requested a determination that the secured bondholders, defendants in the adversary proceedings, were undersecured.[42] In support of their contention, the debtors and the creditors' committee argued that the secured bondholders only would be entitled to interest, fees and costs if they were oversecured on a debtor-by-debtor basis without reference to value of any other collateral securing the bondholders' claim, which collateral was owned by other debtor entities.[43] The debtors and creditors' committee also argued that "even where a creditor's claim is secured by collateral pledged by other debtors, it is necessary to examine the value of a specific 'estate's interest' under section 506(a) to determine whether the secured creditor is entitled to postpetition interest with respect to its claim against that particular debtor under section 506(b)."[44] The secured bondholders disagreed with the plaintiffs' argument arguing that the collateral should be aggregated across all debtors.[45]

The *Residential Capital* court stated that the debtors and creditors' committee's "view seems to follow from the general principle that, absent substantive consolidation, a court will not pool the assets of multiple debtors to satisfy their liabilities."[46] However, the court also noted that "aggregating collateral for purposes of determining whether a secured creditor is oversecured and

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[38]Residential Capital, LLC, 501 B.R. at 555.

[39]Residential Capital, 501 B.R. at 556.

[40]*Off'l Cmte. of Unsecured Creditors v. UMB Bank N.A. et al. (In re Residential Capital LLC, et al.)*, Adv. Pro. 13-01277, Complaint (Bankr. S.D.N.Y. February 28, 2013) [Dkt. No. 1] and *Residential Capital, LLC, et al., v. UMB Bank N.A. et al. (In re Residential Capital LLC, et al.)*, Adv. Pro. 13-01343, Complaint (Bankr. S.D.N.Y. June 19, 2013) [Dkt. No. 1].

[41]See Case No. 13-01277, Consolidation and Scheduling Order [Dkt. No. 41].

[42]Residential Capital, 501 B.R. at 556.

[43]Residential Capital, 501 B.R. at 598.

[44]Residential Capital, 501 B.R. at 598.

[45]Residential Capital, 501 B.R. at 598.

[46]Residential Capital, 501 B.R. at 598.

entitled to postpetition interest and fees does not run afoul of this rule. No debtor in a multi-debtor case will be required to pay a secured creditor more than the value of the collateral."[47]

The court found that the secured bondholders "must be allowed to aggregate collateral held at each of the Debtors in order to calculate the extent of their security."[48] In reaching its decision, the *Residential Capital* court reasoned that "any other reading of the statute would lead to inequitable and illogical results."[49] Moreover, the *Residential Capital* court stated that "defendants' view more accurately reflects the reality of this case. It also reflects the workings of the business world at large."[50] The court referenced the flexibility to move assets between entities, employ varying corporate structures for tax purposes, the limitation of liability and compliance with regulatory requirements when it reasoned that if secured creditors were required to be oversecured on an entity-by-entity basis, such requirement could "prohibit corporate entities from employing the type of complex subsidiary and affiliate structures that are currently commonplace" and siding with the plaintiffs could result in new requirements by lenders for borrowers to hold all collateral at a single entity.[51] Moreover, lenders might require approval before moving collateral among entities, be less willing to extend credit, or would charge higher interest rates in order to compensate for the possibility that they would not be paid for interest, fees, costs and charges in bankruptcy.[52] Finally, the court concluded as follows:[53]

> [I]f the [P]laintiffs' view is accepted, section 506(b) will effectively be nullified in multi-debtor cases where a secured creditor is not oversecured at any single debtor even in instances where the creditor is vastly oversecured by the property held by the debtors in the aggregate. An interpretation of section 506(b) that allows for this scenario defies common sense. For all these reasons, the Court holds that the [secured bondholders] must be allowed to aggregate collateral held at each of the Debtors in order to calculate the extent of their security.

III. CONCLUSION

Over the past year, the section 506 case law has evolved in the

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[47]Residential Capital, 501 B.R. at 598.

[48]Residential Capital, 501 B.R. at 602.

[49]Residential Capital, 501 B.R. at 598.

[50]Residential Capital, 501 B.R. at 601.

[51]Residential Capital, 501 B.R. at 601–02.

[52]Residential Capital, 501 B.R. at 601–02.

[53]Residential Capital, 501 B.R. at 601–02.

commercial area focusing on (a) determining the appropriate rate of default interests and (b) how to value a collateral package in multi-debtor cases. These are issues routinely arising in today's commercial bankruptcy cases. With respect to default interest, once a court determines that default interest may be awarded based upon the value of the collateral exceeding the claim amount and based upon the terms of the contract, courts will either award the contractual rate of default interest or some other "reasonable" rate of interest. If a court reviews the reasonableness of the contractual rate of default interest, the court will analyze the facts and circumstances of the case and balance the equities to arrive at a default interest rate that is reasonable. Such rate, may, in the end, be the contractual rate of default interest or some other reasonable rate based upon the evidence submitted. More importantly, the right to default interest may be dependent upon whether a lender accelerated its loan pre-bankruptcy.

With respect to multi-debtor cases, two recent cases have held that secured creditors are oversecured if the aggregate value of the collateral across all debtors exceeds the amount of the secured creditors' claim, even if the secured creditors would be undersecured on a debtor-by-debtor basis. Given the dearth of case law in this area and given the increase in valuation disputes in bankruptcy cases generally, other courts likely will be faced with this same issue and it will be interesting to see whether the holdings of *Revolution Dairy* and *Residential Capital* are followed or if other courts begin to diverge from these holdings.