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Flexible Valuation and Postpetition Interest

First Circuit Gives Broad Discretion to Bankruptcy Courts

The First Circuit Court of Appeals in Boston recently rendered a decision that may be of interest to secured lenders. The First Circuit held that bankruptcy courts should take a flexible approach when valuing collateral and that a secured creditor's right to postpetition interest, fees, and charges may fluctuate as the value of the creditor's collateral changes during the course of a Chapter 11 case.

The decision *The Prudential Ins. Co. of America v. SW Boston Hotel Venture, LLC (In re SW Hotel Ventures, LLC)*, Case Nos. 12-9008 and 12-9009 (1st Cir. April 11, 2014), involved a hotel/condominium development project that had been financed, in part, by a secured loan from The Prudential Insurance Co. of America. Shortly after the project's owners commenced chapter 11 proceedings, Prudential sought relief from the automatic stay, arguing that its total debt, determined by the bankruptcy court to be \$154 million, was secured by collateral with an aggregate value of only \$141 million. In the course of the relief from stay proceedings, the bankruptcy court concluded that the debtor's collateral had a value of \$153.6 million, slightly less than the outstanding amount of Prudential's claim. As an undersecured creditor with respect to the debtor's assets, Prudential would not have been entitled to recover postpetition interest, fees, and charges as a component of its claim pursuant to 11 U.S.C. § 506(b). Generally, creditors can only charge postpetition interest to a debtor if the value of the creditor's collateral owned by the debtor exceeds the amount of the creditor's claim.

Soon after the relief from stay denial, the debtor proposed a sale of the hotel and parking garage for a price well in excess of the value adopted by the bankruptcy court in its earlier valuation. Based on the sale price, it appeared that, contrary to the bankruptcy court's prior finding, Prudential was oversecured and could potentially recover postpetition interest, fees, and charges. Prudential filed a motion seeking to include postpetition interest in its claim from the petition date, pursuant to 11 U.S.C. § 506(b), arguing that the hotel/garage sale price provided the best indicator of the project's value from the outset of the case. The debtor acknowledged that Prudential was oversecured but argued that Prudential only became oversecured when the hotel and parking garage were sold. The debtor also argued that the default interest that Prudential sought to collect constituted an unenforceable penalty under the state law that governed the parties' loan agreements or was otherwise unenforceable because of federal equitable principles. Given that a year had passed between the petition date and the hotel/garage sale, and given the default interest rate of 14.5 percent, Prudential stood to collect or lose millions of dollars, depending on the date on which it became oversecured for § 506(b) purposes.

The bankruptcy court analyzed case law from other jurisdictions concerning the timing of collateral valuation in bankruptcy. The bankruptcy court noted that some courts adopted a single valuation approach such that a creditor's oversecured status and entitlement to postpetition interest is determined as of the petition date, without an opportunity to revisit the issue. Other courts have adopted a flexible approach, and the right to postpetition interest can change throughout a bankruptcy case as collateral values and claim amounts change with market conditions and payments. The bankruptcy court adopted the flexible approach and determined that Prudential became oversecured upon the hotel/garage sale and was only entitled to receive postpetition interest from that point forward. The bankruptcy court's decision was reversed by the First Circuit Bankruptcy Appellate Panel and a further appeal was taken to

the First Circuit Court of Appeals.

The First Circuit Court of Appeals affirmed the bankruptcy court's decision concerning Prudential's right to postpetition interest pursuant to 11 U.S.C. § 506(b). The Court of Appeals found no error with the bankruptcy court's decision that the value of the debtor's assets could be determined at different times in the course of the case and that an increase or decrease in value could affect Prudential's right to postpetition interest. The First Circuit similarly affirmed the bankruptcy court's finding that the hotel/garage sale price was not necessarily indicative of its value at any earlier point in the case, given that many contingencies to the sale were unresolved until shortly before closing. The decision does not mandate a multiple valuation approach in all cases but leaves the manner and timing of collateral valuation to the bankruptcy courts.

With respect to the debtor's challenge to Prudential's default interest claim, the First Circuit affirmed the bankruptcy court's decision that the default rate set forth in the parties' loan agreements was presumptively valid. Based on the evidentiary record in the bankruptcy court, the First Circuit affirmed the allowance of default interest because the debtor had not carried its burden of demonstrating that the default interest rate was an unenforceable penalty under state law. Similarly, the debtor had not demonstrated that the default interest should be disallowed under federal equitable principles. Specifically, the First Circuit noted the bankruptcy court's findings that (1) other creditors would not be harmed by the allowance of default interest because the debtor's plan called for full payment of all creditors; (2) the evidence presented demonstrated the consistency of the default rate with default rates in similar loans; and (3) bankruptcy courts had approved a larger base to default interest rate spreads in other cases.

The *SW Hotel Ventures* decision is an important reminder to secured creditors that considering collateral values at different points in a prolonged Chapter 11 case may provide an opportunity to recover postpetition interest and fees, but this right may be lost if initial collateral valuations are not reexamined. The execution of leases, permitting or zoning changes, or the resolution of previously uncertain environmental liabilities can dramatically affect the value of a secured creditor's collateral in the course of bankruptcy proceedings and result in a previously undersecured creditor becoming oversecured (or vice versa). The decision highlights the need for secured creditors to monitor developments during the case that could affect the value of their collateral and to then reassess options as changes occur.

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