Recent Bankruptcy Cases Protect Contract Interest Rates

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I. Introduction

In conjunction with the possibility of a "crashingdown" of secured debt under Bankruptcy Code section 1322(b)(2), a concern for secured lenders under Chapter 13 bankruptcy cases has been the bankruptcy court's authority to approve a Chapter 13 plan significantly reducing the contract rate of interest. Section 1322(b)(2) permits such a plan to "modify the rights of holders of secured claims" (subject to an exception essentially limited to home mortgage loans). Section 1325(a)(1) requires the bankruptcy judge to confirm the plan, except as provided therein; section 1325(a)(3)(B) prohibits confirmation unless the relief is "fair and equitable for the holder of the claim or interest." Section 1325(a)(10) is particularly important to a lender who has extended credit to a high-risk borrower in return for a high contract rate of interest.

One such case is that a lender will assume considerable credit risk in return for a high contract rate, only to have the debtor file bankruptcy in order to unilaterally rewrite the contract and protect reduce the interest rate in a Chapter 13 plan. Unlike a Chapter 11 case, Chapter 13 does not require creditor acceptance of the plan; therefore, judicial oversight pursuant to section 1325(a) is one of the few safeguards against abuse by the debtor.

Fortunately, in this context the bankruptcy courts and by large have exercised their authority under section 1325(a) in a reasonable manner. A recent decision from the bankruptcy Court for the Western District of Oklahoma illustrates this trend.

II. The Smith Case

In Smith, a secured creditor objected to confirmation of a Chapter 13 plan and section 1325(a)(3)(B)(i) and (ii) constitute an important protection for secured creditors. Section 1325(a)(10) is particularly important to a lender who has extended credit to a high-risk borrower in return for a high contract rate of interest.

The secured creditor argued that the contract rates (in the range of 196%-21%) represented the market rates for such loans, and were therefore necessary to preserve the value of money for the credit as required under section 1325(a)(5)(B)(i) and (ii). The debtor argued that the filing of bankruptcy and provision for repayment in a Chapter 13 plan (with provision from other creditor processes by reason of the automatic stay) improved the debtors' risk profiles during the pendency of the cases, justifying a lower interest rate.

The Smith court decided against the use of expert witnesses, instead deciding the cases on the basis of the statute and existing authorities. The court noted that section 1325(a)(5)(B)(i) imposes no requirement or protection with regard to unsecured claims. Unsecured claims frequently receive no payment whatever in Chapter 13, despite Bankruptcy Code provisions suggesting that at least some payment was anticipated by Congress as compensation to creditors for the broader discharge provisions and other debtor benefits of Chapter 13.

Secured debt may be bifurcated into secured and unsecured claims, and the unsecured portion will be treated like other unsecured debts for purposes of participating in payments made under the Chapter 13 plan. The secured claim (and lien) may then be subject to modification under section 1322(b)(2), and holders of certain types of secured debt may receive less than 100% of the contract rate.

It is important to remember that the 100% payment of principal is provided for in the plan, the contract rate of interest may be modified under section 1322(b)(2)(B),[2] subject only to the protection of section 1325(a). Therefore, section 1325(a)(5)(B)(ii) plays a pivotal role. The essential question in such cases, faced squarely by the court in Smith, is the extent to which section 1325(a)(5)(B)(ii) permits modification of the contract interest rate in a Chapter 13 plan.

III. Other Cases Considered in Smith

The Smith court reviewed a number of other cases that have considered this issue.

The Smith court cannot adequately extend the analysis of this court to consider the rates of interest being charged in similar loans by other lenders, as well as the rates being charged or comparable loans by the same lender.[10] Jones held that the appropriate rate is that which the lender would charge on a similar loan as of the date of the plan confirmation. Jones further held that, absent significant inter- esting conditions in an Oklahoma City market (a material change in market rates, the contract interest rate should be used. In effect, the contract rate serves as the foundational evidence in determining the market rate in a Chapter 11 case. Absent significant evidence to the contrary, the contract rate should be used.[11]"}

V. Analysis and the Decision in Smith

The Smith court adopted the reasoning in Harding and Jones, concluding that the best evidence of the market rate of interest is the rate currently being charged on comparable loans by the same creditor. The court also concluded that the analysis should begin with the contract interest rate, indicating that this rate should be used in the Chapter 13 plan. Absent significant evidence that there has been a "substantial change in market rates" since the contract date, absent such change, "[t]his court will not permit a permitted debtor in bankruptcy to obtain confirmation of a cramdown Chapter 13 plan which provides for interest at a rate 13% below the best rate the debtor could otherwise obtain outside of bankruptcy." Harding and Jones, respectively, are important to the decision in this case. In the context of Chapter 13 interest rate determinations. Moreover, this viewpoint reflects a near-unanimous trend of authority, as evidenced by other recent bankruptcy cases.

The logic of this analysis seems inevitable, and Smith, in conjunction with Harding and Jones, represents an important step in providing a clear interpretation of section 1325(a)(5)(B)(ii) in the context of Chapter 13 interest rate determinations.
VI. Other Recent Cases

Other recent bankruptcy cases from diverse jurisdictions suggest a widespread consensus that is consistent with the Smith analysis. For example, In re Rienkardt applied a market rate with a presumption in favor of the contract interest rate, in order to determine the present value of the lender's secured claim under section 1325(a)(5)(B)(ii). In re Hollin similarly followed Jones in holding that the appropriate rate of interest is that "for a loan similar in character, amount and duration to the credit which the creditor [must] extend under the plan." 32

Suggesting again that any adjustment from the contract rate should be upward, In re Galavas held that the "market rate plus" is the appropriate standard under section 1325(a)(5)(B)(ii). While adopting a "case by case" approach, the court described a two-step procedure whereby the court determines the current market rate for similar loans and then considers a possible upward adjustment based on risk factors and the lender's lost opportunity costs.

VII. Conclusion

The courts seem to be forging a consensus on this issue that is rare in bankruptcy jurisprudence today. Smith is one of the best-reasoned of these cases, and should provide valuable guidance for courts considering this issue.

Recent Cases Reflect Continuing Risks to Secured Lenders From Bankruptcy Preference Rules

By Alvin C. Harrell

I. Perfection of a Non-Purchase Money Security Interest or Recordation of a Mortgage As an Avoidable Preference

Over the past decade secured lenders (particularly auto lenders) have faced a problem when their borrowers filed bankruptcy within 90 days after buying a car and then sought to avoid the lender's security interest under Bankruptcy Code section 547. The problem arises because the necessity to obtain or issue a certificate of title prior to lien entry means that the security interest is typically perfected after the loan is closed and funded. Under the Bankruptcy Code, this subsequent perfection constitutes a transfer to the secured party on behalf of an antecedent debt, thereby potentially enabling the debtor to avoid the perfection as a preferential transfer under section 547. A pair of U.S. Court of Appeals decisions and some recent Bankruptcy Code amendments have ameliorated this concern somewhat for purchase-money auto lenders. 5 But now similar problems have arisen in the context of other scenarios involving non-purchase money Article 9 security interests and real estate mortgages, with broad implications for all secured lenders.

In re Product Design and Fabrication, Inc. involved a non-purchase money security interest in equipment, perfected by filing a financing statement. Within the 90 days prior to bankruptcy, the secured party closed and funded loans to the debtor and the parties executed security


3. In re Boumber, 918 F.2d 958 (10th Cir. 1990).


