UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re: Bk. No. 99-11087-JMD
Chapter 11

Shepherds Hill Development Co., LLC,
Debtor

Edmond J. Ford, Esq.
FORD & WEAVER, P.A.
Chapter 11 Trustee

Jack S. White, Esq.
WELTS, WHITE & FONTAINE, P.C.
Attorney for Leonard A. Vigeant

MEMORANDUM OPINION AND ORDER

I. BACKGROUND

On March 28, 2000, Edmond J. Ford, the Chapter 11 trustee in the above-captioned bankruptcy case (the "Trustee"), filed an objection to various creditors' claims. One of the claims objected to by the Trustee is a secured claim held by Leonard A. Vigeant ("Vigeant"). The instant controversy is limited to this claim only. In his proof of claim, Vigeant assesses the amount of his claim to be $3,011,406.45, which is derivative of a promissory note and mortgage entered into between Vigeant and the Shepherds Hill Development Co, LLC (the "Debtor").

Before the legal arguments of the parties may be discussed, a brief description of the terms of the note and mortgage is necessary. The parties entered into a note and mortgage on October 7, 1997 (respectively, the "Note" and "Mortgage"). The Note involves a principal amount of $2,650,000.00, with an outside maturity date of January 5, 1998. The Note provides an interest rate of 8 percent and a default interest rate equal to 18 percent. The Mortgage reiterates the principal amount and interest rate of 8 percent, but fails to explicitly mention the 18 percent default rate. It is undisputed that the Debtor is in default under the terms of the Note.

In addition to the Note and Mortgage, at least two other agreements directly affect the instant matter. On August 26, 1998, Vigeant and Robert Quirk ("Quirk") entered into an option agreement concerning the Note ("Option One"). Under Option One, Quirk agreed to pay Vigeant $200,000.00 for the right to purchase the Note from Vigeant for $2,638,634.14, a price which reflects a $200,000.00 reduction for the purchase price of the option. Quirk's rights under the Option ran from its date of execution until October 26, 1998. In addition to Option One, Vigeant and Quirk entered into a second option on December 9, 1998 ("Option Two"). Under Option Two, Quirk agreed to pay Vigeant $50,000.00 for the right to purchase the Note from Vigeant for $2,734,214.00 plus accrued interest, less the $50,000 option price. Quirk's rights under Option Two expired by its terms on January 29, 1999. A handwritten addendum to Option Two indicates that the $50,000.00 payment is to be credited to the Mortgage. It is undisputed that Quirk did not exercise his rights under either Option One or Option Two. It is also undisputed that Vigeant received all monies owed him by Quirk pursuant to Option One and Option Two.

The Trustee objects to the amount of Vigeant's claim on the following grounds:

1. Despite the Debtor's default, the rate of interest connected with Vigeant's secured claim should be limited to 8 percent, since the Mortgage fails to mention the 18 percent default rate.

2. Post-petition interest should be limited to 8 percent since the 18 percent default rate is punitive.

3. The $50,000.00 payment made pursuant to Option Two should be credited entirely against the principal amount of the Note since the documentation underlying Option Two does not allocate said amount towards principal or interest.

4. Because Vigeant received $200,000.00 from Quirk pursuant to Option One, $200,000.00 of his principal claim, together with associated interest amounts, should be subordinated to the claims of unsecured creditors.

Although Vigeant filed an objection to the Trustee's various arguments, wherein he maintained that his claim should be allowed in full in accordance with the terms of his proof of claim, the parties did find some common ground at the May 15, 2000 hearing on the instant matter. At that hearing, the parties agreed that the $50,000.00 payment pursuant to Option Two would be bifurcated equally between interest and principal regarding the Note. In other words, the parties agreed that $25,000.00 shall be allocated towards interest on

the Note, while $25,000.00 shall be allocated towards principal. Accordingly, the Trustee's third ground for objecting to Vigeant's claim is rendered moot by the parties' agreement. However, because agreement between the parties ends there, the Trustee's remaining grounds must be addressed.

The Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. DISCUSSION

Because the Trustee's three remaining grounds for objecting to the amount of Vigeant's claim are largely independent of one another, they shall be discussed seriatim.

A. Whether the Mortgage Should Control the Applicable Interest Rate

The Trustee argues that because the Mortgage only mentions the Note's 8 percent base rate, and fails to mention the Note's 18 percent default rate, only the amount flowing from an 8 percent interest rate on the Note should be included in Vigeant's secured claim and any additional interest should form an unsecured claim. The Trustee's argument fails for two alternative reasons; one contractual and the other flowing from general legal principles.

First, the contractual language of the Mortgage clearly evidences the parties' intention that 18 percent would be the default rate of interest. The Mortgage provides, in pertinent part:

> [T]hat to secure the payment of an indebtedness in the sum of [$2,650,00.00], to be paid as provided for in a Note of even date with interest thereon to be computed from the date hereof, at the rate of [8%] per annum, to be paid as set forth in said Note, and according to said Note bearing even date herewith, the Mortgagor hereby grants to the Mortgagee . . . .

Ex. A to Vigeant's Response dated October 7, 1997, at 1 (emphasis added). Through this language, the Mortgage incorporates all terms found in the Note, including the 18 percent default term. Although the Mortgage does not mention the 18 percent default term, such an omission does not conflict with the 18

percent default term found in the Note. Instead, it merely omits the default rate explicitly, but incorporates it by reference. Although the Mortgage may not a model of precise drafting, in the end it gets the job done.

In addition to being contrary to the contractual language of the Mortgage, the Trustee's argument fails based on general legal principles germane to the instant matter. As a general rule, a note and a mortgage shall be construed together for interpretive purposes. See Frenzel v. Frenzel, 152 N.W.2d 157, 160 (Iowa 1967). Moreover, when terms in a note and mortgage conflict, the note generally controls since it is the primary obligation and the mortgage is merely an incident thereto. See id. Here, as discussed, the Note and the Mortgage do not conflict; the Mortgage explicitly provides for the 8 percent base interest rate and incorporates the default rate by reference. Construing the two documents together, it is clear that the parties intended for there to be an 18 percent default interest rate.

B. Whether Post-Petition Interest Should be Limited to 8 Percent

The Trustee argues that, despite the fact that the Debtor was in default under the Note as of the petition date and therefore triggered the 18 percent default rate pursuant to the Note, post-petition interest on the Note should be limited to the base contract interest rate of 8 percent. The Trustee bases his argument on the ground that the 18 percent default rate is punitive in nature.

The applicable law governing the Trustee's second argument originates in 11 U.S.C. 506(b),[1] which provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

11 U.S.C. § 506(b). In essence, § 506(b) provides, inter alia, that an oversecured creditor may add post-petition interest to the amount of his or her claim to the extent the claim is oversecured. See 4 King et al., Collier on Bankruptcy ¶ 506.04[2] (15th rev. ed. 1999). It is undisputed that Vigeant is oversecured. The crucial question, therefore, is at what rate may Vigeant add post-petition interest to the amount of his claim.

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[1] Unless otherwise noted, all section references hereinafter are to Title 11 of the United States Code.

More precisely, the instant issue may be distilled to a simple question: may Vigeant calculate post-petition interest according to the contractual default rate of 18 percent, or should he be limited to a lesser rate?

In the context of consensual security interests as viewed through the lens of § 506(b), it is generally held that the contract rate agreed to by the relevant parties should be afforded a high degree of deference.[2] See Bradford v. Crozier (In re Laymon), 958 F.2d 72, 74 (5th Cir. 1992) ("Therefore, we hold that when an oversecured creditor's claim arises from a contract, the contract provides the rate of post-petition interest."). However, such a holding is tempered by the view that, pursuant to § 506(b), contractual rates of interest may be modified to avoid an inequitable or unconscionable result. See id.; In re Terry Ltd. Partnership, 27 F.3d 241, 243 (7th Cir. 1994) (recognizing "a presumption in favor or the contract rate subject to rebuttal based upon equitable considerations."); Fischer Ent., Inc. v. Geremia (In re Kalian), 178 B.R. 308, 313 (Bankr. D.R.I. 1995) ("[B]ankruptcy courts give deference to the parties' agreed interest term, but may modify the rate in appropriate circumstances."); DeMaggio, 175 B.R. at 148 ("[T]he federal court will normally enforce a contractual rate of interest agreed to by the parties in the absence of any strong and unique countervailing factors.").[3] Although the Court gives great deference to the 18 percent default interest rate originally agreed to by the parties, it will use an alternative rate if applying the default rate yields an inequitable result.[4]

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[2] The world of non-consensual liens is governed by slightly different rules. In that cosmos, many courts appear to be less deferential to state statutory rates and instead are more willing to apply alternative rates of interest. See, e.g., In re DeMaggio, 175 B.R. 144 (Bankr. D.N.H. 1994) (using the federal judgment rate instead of the higher state statutory rate in computing the post-petition interest with respect to non-consensual state tax and general assistance liens).

[3] There is, however, a contrary, but less popular, view. The leading treatise on bankruptcy law takes a restrictive view in opining that, in the context of § 506(b), post-petition interest should reflect agreed upon contractual rates in almost all circumstances. See 4 King et al., Collier on Bankruptcy ¶ 506.04[2][b] (15th rev. ed. 1999). Such a view appears to attach too much weight to the notion of sanctity of contract. Bankruptcy, at its core, involves the upsetting and modification of contractual rights subject to certain safeguards. Moreover, bankruptcy courts are courts of equity and therefore imbued with the power to alter legal contractual rights.

[4] At least one court has approached the default rate issue from a different angle. In Kalian, Judge Haines, sitting by designation, reasoned that a default interest rate may be viewed as a "charge" under § 506(b), and therefore subject to an explicit statutory requirement of reasonableness. See Kalian, 178 B.R. at 316-17. Judge Haines, in reaching his conclusion, quoted the fabled dog riddle attributed to Abraham Lincoln: "'If you call a tail a leg, how many legs has a dog?' The answer: 'four, because calling a tail a leg

Some courts find a default rate of interest to be equitable, and therefore the applicable rate of post-petition interest pursuant to § 506(b), when it is shown that such a rate is typically charged by comparable creditors. See, e.g., In re Courtland Estates Corp., 144 B.R. 5, 9 (Bankr. D. Mass. 1992). The Supreme Court's decision in United States v. Ron Pair Enters., Inc., 489 U.S. 235, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989) has been characterized as establishing a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations. See id.; Terry Ltd. Partnership, 27 F.3d at 243. In this case, the spread between the pre-default and post-default contractual interest rates is ten percent, or an increase of 125 percent. The Court notes that the terms of the Note reflect that Vigeant was providing only interim seller financing for the Debtor (i.e., a term of 90 days). Under such circumstances, it might not be inappropriate for the Note to create a disincentive with respect to any attempt by the Debtor to convert the Note into longer term financing, in addition to compensating the holder of the Note for the unforeseeable costs and risks associated with a defaulting borrower. However, no evidence was presented by the parties concerning the commercial reasonableness of an 18 percent default rate under the circumstances. In fact, the parties presented very little evidence concerning the parties' motivations with respect to the default rate.

At bottom, the Trustee argues that the rate is "punitive," while Vigeant argues that it is not. At the hearing, however, Vigeant stated that he would be amenable to a 14 percent rate with respect to post-petition interest. After considering the absence of an evidentiary record, the concession offered by Vigeant at the hearing, and the history of the loan to the Debtor, the Court cannot say that a default interest rate of 14 percent is unreasonable or inequitable. Accordingly, the Court finds that 14 percent is an equitable rate of interest and therefore holds that the post-petition default interest rate shall be 14 percent annually instead of 18 percent.

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doesn't make it a leg.'" Id. at 313 n. 11. In other words, it is Judge Haines's view that just because a default term is labeled an interest rate, it does not make it so. There is certainly strength in Judge Haines's reasoning. However, as Judge Haines would likely concede, it has its limits. Labels, being words, carry with them meaning and often help form the content of something. Of course, as Judge Haines rightly points out, labels cannot carry the day, but they do bring with them great weight. Accordingly, this Court would likely not transform a default rate labeled as interest into a § 506(b) "charge" without clear evidence that considering it an interest rate is plainly incorrect. In any event, the Court will not pass on this issue since neither party has elected to raise it.

C. Whether the $200,000.00 Payments Under Option One Should be Subordinated

The Trustee argues that the $200,000.00 received by Vigeant from Quirk pursuant to Option One should be subordinated to the claims of unsecured creditors. The Trustee argues that, unless the $200,000.00 is subordinated, Vigeant will receive an unfair windfall in that he will have received $200,000.00 from Quirk without a corresponding reduction in the amount of the debt that made Option One possible. In other words, the Trustee argues that subordination will avoid Vigeant being allowed to receive $200,000.00 "twice."

Although he does not reference the Code section explicitly, the Trustee presumably looks to § 510(c) as the vehicle for his argument, a provision that allows a court to subordinate a claim to another claim under principles of equitable subordination. See 11 U.S.C. § 510(c). Section 510(c) is generally read narrowly to allow subordination only when it is shown that a party has engaged in some form of misconduct. See 4 King et al., Collier on Bankruptcy ¶ 510.05[1] (15th rev. ed. 2000). Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977) is the seminal case defining the parameters of equitable subordination and requires the following three factors to be present before equitable subordination may be used:

1. The claimant must have engaged in some type of inequitable conduct.
2. The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
3. Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.

See Mobile Steel, 563 F.2d at 699-700. This test has been adopted by courts in this circuit. See Katz v. Dept. of Justice (In re Bellucci), 29 B.R. 814, 815 (B.A.P. 1st Cir. 1983); Ferrari v. Family Mutual Sav. Bank (In re New Era Packaging, Inc.), 186 B.R. 329, 335 (Bankr. D. Mass. 1995). The initial requirement is that the claimant must have engaged in inequitable conduct; an inequitable result is not enough on its own. See United States v. Noland, 517 U.S. 535, 539 (1996) ("'[A]lthough [a bankruptcy court] is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable.'") (quoting DeNatale & Abram, The

Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors, 40 Bus. Law. 417, 428 (1985)).

No evidence was presented showing that Vigeant engaged in inequitable conduct in connection with Option One, the Note, or a combination of the two. Option One and the Note, although related in that Option One is an option on the Note, are formally and substantively two separate agreements. The Note was an agreement between Vigeant and the Debtor regarding a loan, while Option One was an agreement between Quirk and Vigeant granting Quirk an option to purchase the Note. By granting Quirk an option to purchase the Note and agreeing not to foreclose on the property covered by the Mortgage in exchange for the $200,000.00 option payment, Vigeant provided additional consideration beyond his obligations under the Note. An option is exactly what its name implies: an optional right to do something. Such a right carries value, even if it is ultimately not exercised. The parties apparently determined that right to be worth $200,000.00, and there is no evidence that such a value was incorrect. Accordingly, the Court sees no reason to characterize Vigeant's actions in connection with Option One and the Note as inequitable. Consequently, his claim is not subject to equitable subordination.

III. CONCLUSION AND ORDER

For the reasons stated above, the Court orders the following:

1. The pre-petition default rate of interest on Vigeant's secured claim under the Note shall be 18 percent.

2. The post-petition default rate of interest on Vigeant's secured claim under the Note shall be 14 percent.

3. Pursuant to the agreement of the parties, the $50,000.00 payment received by Vigeant pursuant to Option Two shall be allocated as follows: $25,000.00 shall be allocated toward pre-petition interest on the Note, while the remaining $25,000.00 shall be allocated toward principal on the Note.

4. The $200,000.00 received by Vigeant pursuant to Option One shall not result in $200,000.00 of his secured claim being subordinated.

5. On or before June 21, 2000, the parties shall submit to the Court a proposed order determining the amount of Vigeant's claim as of the petition date and as of June 27, 2000, together with a per diem interest rate applicable after that date, in accordance with this Court's rulings.

This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7051.

DONE and ORDERED this 6th day of June, 2000, at Manchester, New Hampshire.

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J. Michael Deasy
Bankruptcy Judge