Appeal History:

Affirmed by B. A. P. 226 B. R. 198

In the United States Bankruptcy Court

for the Northern District of Iowa

Western Division

DIRECT TRANSIT INC. Bankruptcy No. 96-52691XS

Debtor(s). Chapter 11

ORDER RE:

MOTION FOR ALLOWANCE AND PAYMENT OF SECURED CLAIM

The matter before the court is the motion filed by the South Dakota Governor's Office of Economic Development (GOED) for allowance and payment of its secured claim. The motion was filed July 30, 1997 (Doc. 825). On October 2, 1997, debtor Direct Transit, Inc. (DTI) filed a resistance to the motion, disputing GOED's inclusion of liquidated damages in the calculation of the claim (Doc. 908). After telephonic hearing December 5, 1997, the parties agreed to submit the matter on stipulated facts and briefs. A Stipulation of Facts was filed April 7, 1998 (Doc. 1046). The parties have filed briefs (Docs. 1044, 1047). The court considers the matter fully submitted and now issues its findings and conclusions. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B).

GOED's claim is based on loans it made to DTI in 1992 and 1995. The documents evidencing the loans are attached to GOED's amended proof of claim (Claim No. 748, filed May 27, 1997, amending Claim No. 303). Facts, ¶¶ 1, 2. The relevant documents include a promissory note, real estate mortgage and Agreement Relating to Employment, all dated September 29, 1992, and a promissory note and Agreement Relating to Employment both dated on or about January 26, 1995. Id.

The mortgaged real estate has been sold; the funds are being held in escrow. GOED is a fully secured creditor. The proceeds are sufficient to pay GOED's claim in full to the extent authorized by 11 U.S.C. § 506(b). Facts, ¶ 5.

The mortgage was given as security for various obligations, including "[t]he payment in full of all other present or future debts and liabilities of [DTI] to [GOED] of any nature whatsoever." Claim No. 748, Mortgage at 2, ¶ D. The mortgage secures DTI's obligation under each Agreement Relating to Employment (the "Employment Agreement").

The loans to DTI were made from the Revolving Economic Development and Initiative Fund (REDI). Employment Agreement at 1. The REDI Fund was established for the purpose of making low interest loans to stimulate economic development in South Dakota. Facts ¶ 7.

The 1992 note was in the amount of $200,000 at 3 percent interest. The 1995 loan was for $500,000 at 2 percent interest. Commercial interest rates at the time were 10 percent and 8 percent, respectively. Employment Agreements at 2.

The Employment Agreement stated: "The consideration for [GOED] making said loan is the creation of employment

opportunities for South Dakota citizens...." Id. at 1. The Agreement further provided:

> The parties specifically agree that due to the nature of the consideration for said loan being made by [GOED] it would be impracticable or extremely difficult to fix the actual damages resulting from the breach of the Loan Authorization.
>
> The parties specifically agree that should Borrower substantially change the nature of the Project so that the employment projections are not met, or cease operations or relocate so that there is a loss of the employment created by the Project in South Dakota, within eight years from the date of this agreement, Borrower shall, to the extent the principal amount of the REDI loan shall not have been paid, prepay the remaining principal amount of the REDI loan in full, plus all unpaid accrued interest thereon and shall in addition pay liquidated damages pursuant to the following computation:
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> > Damages shall be due and owing [GOED] in the amount of the difference between the total interest paid on each date prior to the final payment of the loan and on the final payment date (whether at maturity or upon prepayment) and the total interest that would have been paid on those dates had the loan been made at [10% for the 1992 loan, 8% for the 1995 loan], the current commercial rate at the time of this agreement, rather than [3% for the 1992 loan, 2% for the 1995 loan]. If [GOED] demands such liquidated damages five years or more after the date of the loan and each monthly installment payment and the final payment on the loan shall have been made when due without prepayment, the damages due and owing [GOED] would equal [$49,260 for the 1992 loan, $99,180 for the 1995 loan].
>
> This agreement shall be construed pursuant to and in accordance with the laws of the state of South Dakota and any action hereunder shall be brought in a court of competent jurisdiction within the state of South Dakota.

Id. at 2.

DTI was current with payments on the 1992 note through May 20, 1997, and was current with payments on the 1995 note through January 20, 1997. Facts, ¶ 22. On April 8, 1997, DTI breached its obligation under the Employment Agreement to retain employees. Facts, ¶ 27; DTI Brief, Doc. 1047 at 3 (sale of assets and cessation of operations constituted breach of agreement).

DTI and GOED agree that the principal balance of the loans is $171,909.97. The issue is the extent to which GOED is entitled to liquidated damages under the Employment Agreement. The parties have presented three possible methods for calculating GOED's claim. The first method states the amount of the claim "if the court rejects all 'employment damages.'" Facts, ¶ 26. The court assumes this means that accruing interest would be limited to the below market rates of 2 and 3 percent. The claim under the first method would be $175,741.98 plus $13.90 per diem after February 15, 1998. The second method "allows interest at the default rate only after April 8, 1997, the date [DTI] breached its employment covenant," for a total of $186,787.72 plus $54.16 per diem. Facts, ¶ 27. The third method calculates the claim to be $291,793.77 plus $54.16 per diem, the full amount claimed by GOED. Facts, ¶ 28. This amount includes liquidated damages of $104,851.00, based upon the difference between the pre-default contract interest rates and the market interest rates over the life of the loans. Facts, ¶ 6.

> Bankruptcy Code § 506(b) provides:
>
> To the extent that an allowed secured claim is secured by property the value of which ... 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).

DTI first contends that the liquidated damages portion of GOED's claim is in fact default interest. Several courts have

concluded that § 506(b) does not require a bankruptcy court to allow default interest at the contract rate in every case, and that the court may consider the equities of a situation when allowing default interest to an oversecured creditor. Matter of Terry Ltd. Partnership, 27 F.3d 241, 243 (7th Cir. 1994), cert. denied by, Invex Holdings, N.V. v. Equitable Life Ins. Co. of Iowa, 115 S.Ct. 360 (1994); Bradford v. Crozier (Matter of Laymon), 958 F.2d 72, 75 (5th Cir. 1992), cert. denied, 113 S.Ct. 328 (1992); In re W.S. Sheppley & Co., 62 B.R. 271, 278 (Bankr. N.D. Iowa 1986). DTI argues that certain of the factors considered in Sheppley apply equally in this case. DTI Brief at 6-7 (quoting from 62 B.R. at 278). DTI contends that it would be inequitable to award default interest at the expense of unsecured creditors because GOED has never assumed a risk of non-payment and has faced no increased risk after DTI's default. DTI Brief at 6-7. GOED has always been oversecured. DTI proposes to pay GOED's claim immediately after allowance, rather than requiring it to wait for distribution under a plan. DTI argues further that GOED would receive a windfall if the court were to allow default interest retroactively to payments made at the beginning of the loan. Id. at 7.

Although the court may take equitable considerations into account in allowing default interest, the starting point is the language of the contract. In Matter of Laymon the court ruled it was error for the bankruptcy court to find the issue of entitlement to interest under § 506(b) "completely divorced from either the existence or the content of any underlying agreement." 958 F.2d at 74. There is a "presumption in favor of the contract rate subject to rebuttal based upon equitable considerations." Terry Ltd. Partnership, 27 F.3d at 243.

DTI's argument overlooks the nature of the consideration given for the loan. The purpose of the REDI loan program is to stimulate economic development that would create job opportunities in South Dakota. Facts, ¶¶ 7-8. A project's potential for creating jobs is a significant factor in GOED's decision whether to make a loan. Id., ¶ 14. The creation of employment opportunities for South Dakota citizens was consideration for making the low interest loans to DTI. Employment Agreement at 1. Failure to meet employment projections was termed a failure of consideration. Id. Repayment of the loan amount at the pre-default rate of 2 or 3 percent would not give GOED the full benefit of its bargain. At the time the parties made the loan, GOED was at risk that DTI would not meet its employment projections. Now that DTI has ceased operations, GOED is certain not to receive the promised benefit of job opportunities for South Dakota citizens. DTI has not shown that the liquidated damages are inequitable. The retroactive nature of the interest rate may be merely an indicator that the provision for damages is more accurately described as a liquidated damages clause.

An oversecured creditor is entitled to receive, in addition to interest, "any reasonable fees, costs, or charges provided under the agreement under which such claim arose." 11 U.S.C. § 506(b). The parties provided for "liquidated damages" in their Employment Agreement. DTI argues that the liquidated damages provision is in fact an unenforceable penalty. DTI Brief at 8-9. "A liquidated damages clause that is in reality a penalty cannot be enforced in a bankruptcy court." In re Skyler Ridge, 80 B.R. 500, 503 (Bankr. C.D. Cal. 1987). Whether such a clause is an unenforceable penalty is determined by applicable state law. Id. at 504. The parties have agreed that the Employment Agreement would be construed in accordance with the law of South Dakota. Employment Agreement at 2.

The South Dakota Codified Laws provide that "parties may agree [as a term of a contract] upon an amount presumed to be the damage for breach in cases where it would be impracticable or extremely difficult to fix actual damage." S.D. C.L. § 53-9-5 (1997). A liquidated damages clause is generally enforceable--

> if it appears (1) that at the time the contract was made the damages in the event of a breach were incapable or very difficult of accurate estimation; (2) that there was a reasonable endeavor by the parties as stated to fix fair compensation; and (3) that the amount stipulated bears a reasonable relation to probable damages and is not disproportionate to any damages reasonably to be anticipated.

Walter Motor Truck Co. v. South Dakota Dept. of Transportation, 292 N.W.2d 321, 323 (S.D. 1980). Whether a damages clause is a valid provision for liquidated damages or an unenforceable penalty is a question of law. Id. DTI bears the burden of proof that the damages provision is an unlawful penalty. Heikkila v. Carver, 378 N.W.2d 214, 216 (S.D. 1985).

The parties agreed as part of the Employment Agreement that damages for default on the loans would be "impracticable or extremely difficult to fix" because of the nature of the consideration for each loan. Employment Agreement at 2. The

loss of jobs in South Dakota would have a broad range of consequences for the State. See GOED Brief at 9. The loans to DTI appear to be of the type appropriate for a liquidated damages clause. DTI does not dispute this point. The terms of the liquidated damages clause itself, part of an arms-length agreement between parties represented by counsel, is evidence of the parties' efforts to fix fair compensation. Heikkila v. Carver, 378 N.W.2d at 217; Facts, ¶¶ 17-20.

DTI argues that the damages provision has not been structured to compensate GOED for losses caused by the loss of jobs in South Dakota, because DTI could have avoided the damages clause by paying off the loan just prior to ceasing operations. DTI Brief at 8-9. The parties agree that DTI would not have been obligated to pay damages if the loans had been fully paid prior to default on the agreement to maintain employment levels. Facts, ¶ 25. If DTI had prepaid the loan prior to default, GOED would at least have had the return of its money with some interest. In this hypothetical situation, GOED would have had loan funds to offer another business. DTI did not in fact prepay the loan. GOED received neither the prompt return of its money nor the bargained-for employment opportunities. GOED's willingness to forgo further damages in the hypothetical situation does not make the demand for damages in the present situation a penalty. GOED made low interest loans in return for DTI's promise to create employment opportunities in South Dakota. GOED could have instead invested the money at market rates. The liquidated damages clause is reasonably related to damages anticipated in the event of breach. It allows GOED to recapture the difference between the loan rates and market rates. Its effect is to compensate GOED as if it had made a commercial loan. Facts, ¶ 16; GOED Brief at 10-11. DTI has not shown that the damages thus calculated constitute a penalty. The court concludes that GOED's calculation of damages pursuant to the Employment Agreement are reasonable charges within the meaning of 11 U.S.C. § 506(b).

IT IS ORDERED that GOED's Motion for Allowance and Payment of Secured Claim is granted.

SO ORDERED THIS DAY OF MAY 1998.

William L. Edmonds
Chief Bankruptcy Judge

I certify that on I mailed a copy of this order by U.S. mail to counsel for debtor, counsel for unsecured creditors committees, Roger Damgaard, and U.S. Trustee.