

POSTDEFAULT INTEREST RATES IN BANKRUPTCY

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This Article shows that as Bankruptcy Code section 506(b) is currently written, postdefault interest rates are prohibited when the default is an “ipso facto event”—a filing for bankruptcy or insolvency as the event of a default. Yet some courts have insisted on postdefault interest in situations reinstating a loan agreement and have been ignoring restrictions on pendency interest to permit oversecured creditors from obtaining penalty rates of interest. This Article argues that those holdings violate section 506(b) and Supreme Court precedent. It begins with an analysis of ipso facto defaults, showing that the Bankruptcy Code prohibits ipso facto clauses even in nonexecutory contracts. The Article then examines regular monetary defaults. Noting that the Supreme Court only allows compensatory market rates to oversecured creditors, high default interest rates will never be a proxy for the market rate as they constitute penalties. Similarly, the Article argues that the “cure” of loan agreements allowed by reorganization chapters is a compensatory concept, also requiring the market rate of interest. Finally, the Article concludes by arguing that the Bankruptcy Code applies to solvent and insolvent debtors, and thus ipso facto clauses are prohibited and section 506(b) requires compensatory, not punitive, rates even in solvent bankruptcy cases.

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I. INTRODUCTION

Over the years, creditors have learned to demand a hike in the interest rate following a default. When a creditor is unsecured or undersecured, such clauses are useless in light of bankruptcy proceedings. But when creditors are oversecured, they are generally entitled to postpetition interest (i.e., “pendency” interest) pursuant to Bankruptcy Code section 506(b):

To the extent that an allowed secured claim is secured by property the value of which, after any recover 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 or State statute under which such claim arose.¹

The question arises whether oversecured creditors are entitled to receive higher postdefault interest rates called for by the loan agreement, when such higher interest rates deplete the bankruptcy estate at the expense of the unsecured creditors.

It is easy for debtors to agree to such interest rates. Typically, the price is paid not by debtors, who expect to be bankrupt in case of default, but by the unsecured creditors. Every dollar that goes to pay a postdefault interest rate is a dollar that the general unsecured creditor will not receive.² Sometimes, these sums can be very substantial. For instance, in the recent case of *In re SW Boston Hotel Venture, LLC*,³ the award of an extra five percent postdefault interest meant approximately \$8.28 million for the oversecured creditor. In *In re General Growth Properties, Inc.*,⁴ the increment was worth approximately \$7.35 million. In fact, higher postpetition interest rates should be *per se* illegal (or close to it) in bankruptcy proceedings. This is so if we take the text of the Code seriously, as it has been interpreted by the U.S. Supreme Court.

In this Article, I propose to show that, as the Code is currently written, postdefault interest rates are prohibited when the default in question is an *ipso facto* event. I will define an *ipso facto* event as filing for bankruptcy or becoming insolvent in the event of default. In spite of this pro-

1. 11 U.S.C. § 506(b) (2012).

2. It is sometimes assumed that, because the debtor has agreed to higher postdefault interest, the debtor therefore receives a lower predefault interest rate. *Ruskin v. Griffiths*, 269 F.2d 827 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960). But this may be doubted as an empirical matter. In a world of perfect information and absolute competition, this may be so, but that, of course, is not our world. And, even if it were (a rather big “if”), any such contract is rife with externalities. Given these externalities, there can be no question of “efficiency” with regard to the question we are considering (or any other question, for that matter).

3. 748 F.3d 393 (1st Cir. 2014).

4. 451 B.R. 323 (Bankr. S.D.N.Y. 2011).

hibition, courts have nevertheless insisted on postdefault interest in the context of reinstating a loan agreement.⁵ Monetary defaults—where the debtor has failed to pay debt service on time—are not *ipso facto* defaults, and higher postdefault interest and other “liquidated damage” charges are not prohibited *per se*. Yet restrictions on pendency interest severely limit, or perhaps abolish, the effectiveness of higher postdefault interest rates. Courts have been ignoring these restrictions in order to permit oversecured creditors to receive penalty rates of interest. These holdings, I maintain, violate the Bankruptcy Code and ignore Supreme Court precedent.

Part II begins with an analysis of *ipso facto* defaults. I intend to show that the Bankruptcy Code prohibits *ipso facto* clauses in any contract, whether executory or not. Part III examines regular monetary defaults—where a debtor has failed to pay debt service in a timely manner. In my view, the Supreme Court has repeatedly held that, under section 506(b), which authorizes interest compensation to oversecured creditors, only compensatory *market* rates are authorized. If a contract rate is used, it is only because, in the judgment of a bankruptcy court, the contract rate remains a good proxy for the market rate. In any case, high default interest rates are most likely never going to be a proxy for the market rate, as they constitute penalties.⁶ In addition, all the reorganization chapters invite the cure and reinstatement of loan agreements. “Cure,” I will argue, is a compensatory concept, requiring the market rate of interest. In particular, the Bankruptcy Code expressly rules out penalty rates as part of the compensatory cure of past defaults. Part IV briefly argues that, whatever the Bankruptcy Code means, it applies to solvent debtors as well as insolvent ones. Whether the debtor is solvent or not, *ipso facto* clauses are prohibited, and section 506(b) requires compensatory, not punitive, rates.

II. *IPSO FACTO* CLAUSES IN GENERAL

A standard judicial definition of “*ipso facto* clause,” drawn from *Iberiabank v. Beneva 41-I LLC*,⁷ holds that an *ipso facto* clause is one “that provides the consequences if a certain event occurs In bankruptcy, an *ipso facto* clause provides the consequences, such as termination of a contract, upon insolvency or filing of a bankruptcy petition.”⁸

It is well known that the Bankruptcy Code disfavors *ipso facto* clauses, but two misconception persist as to how far the Code really goes in striking down *ipso facto* clauses. First, it is supposed that the policy

5. See, e.g., *id.* at 327.

6. For a recent example, see *In re Parker*, No. 12–03128–8–SWH, 2014 WL 6545025 (Bankr. E.D.N.C. Nov. 19, 2014).

7. 701 F.3d 916 (11th Cir. 2012).

8. *Id.* at 920 n.5; see generally Emil A. Kleinhaus & Peter B. Zuckerman, *The Enforceability of Ipso Facto Clauses in Financing Agreements: American Airlines and Beyond*, 23 NORTON J. BANKR. L. & PRAC. 193 (2014).

against the *ipso facto* clause is limited to executory contracts⁹ governed by section 365. In *In re General Growth Properties, Inc.*,¹⁰ the court remarks, “[a]s a matter of statute, the question whether a bankruptcy default clause should be treated as an invalid *ipso facto* clause depends on whether the contract at issue is an executory contract or unexpired lease.”¹¹ The implication is that *ipso facto* clauses are struck down if they are part of an executory contract, but are perfectly acceptable in so-called “executed” contracts, such as loan agreements.¹²

Second, it is too quickly assumed that an *ipso facto* clause is narrowly limited to “termination of a contract” upon insolvency.¹³ This is not so. The Bankruptcy Code prohibits *any* modification triggered by commencement of a bankruptcy proceeding or like event.

A. *Ipso Facto Clauses in Executory Contracts*

We begin with the premise that *ipso facto* clause regulations apply only in the context of an executory contract. This is too narrow a view, as shown by section 363. Section 363 is the important provision that governs use, sale, or lease of estate property by the bankruptcy trustee. According to section 363(l):

Subject to the provisions of section 365, the trustee may use, sell, or lease property under subsection (b) or (c) of this section, or a plan under chapter 11, 12, or 13 of this title may provide for the use, sale or lease of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects or gives an option to effect, a forfeiture, modification, or termination of the debtor’s interest in such property.¹⁴

This section is “subject to the provisions of section 365,” which, of course, deals with executory contracts. But the scope of section 363(l) is by no means limited to executory contracts.¹⁵ This broad scope reflects the expectation that the trustee might use, sell, or lease property free and clear of *ipso facto* clauses contained in deeds or contracts that are not executory in nature. An executory contract is an *example* of property that a trustee might use, sell, or lease under section 363. In that context, the price of assuming a valuable executory contract is that it must be cured

9. “[E]xecutory contracts are those on which performance remains due to some extent on both sides.” *Sipes v. Atl. Gulf Cmty. Corp. (In re Gen. Dev. Corp.)*, 84 F.3d 1364, 1370 (11th Cir. 1996) (internal quotations omitted).

10. 451 B.R. 323 (Bankr. S.D.N.Y. 2011).

11. *Id.* at 329.

12. See *In re Moody Nat’l SHS Houston H, LLC*, 426 B.R. 667, 673 (Bankr. S.D. Tex. 2010).

13. *Iberiabank*, 701 F.3d at 920 n.5.

14. 11 U.S.C. § 363(l) (2012).

15. *Id.*

and brought current. So “use, sale, or lease” of an executory contract under section 363 is subject to the rule of assumption and cure as governed by section 365.

In the context of executory contracts, two different provisions govern the *ipso facto* clause. According to Bankruptcy Code section 365(e)(1):

Notwithstanding a provision in an executory contract or unexpired lease . . . an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on

- (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
- (B) the commencement of a case under this title; or
- (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.¹⁶

So far, this prohibition on termination or modification simply repeats what section 363(l) has already taught us. But section 365(e)(2) promulgates two exceptions. The first of these applies to what may be called the portrait painting context.¹⁷ Suppose *D* is a famous artist who contracts to paint *C*'s portrait for a hefty fee. The contract gives *C* the right to cancel the contract if *D* files for bankruptcy. *D* is bankrupt and now seeks to sell this “account receivable”—and to delegate the duty of painting the portrait—to *X*, a hack artist whose work is unvalued in the artistic community. *C* may invoke his *ipso facto* right under section 365(e)(2) because “applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from . . . an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties.”¹⁸

Indeed, it is apparent from section 365(e)(2) that the recitation of the *ipso facto* clause in the contract is quite unnecessary, as applicable law pertaining to the delegation of duties protects *C* regardless of the content of the contract.¹⁹

A second exception applies to commitments to lend, “or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.”²⁰ Once again, these obli-

16. *Id.* § 365(e)(1).

17. *See id.*

18. *Id.*

19. *See* RESTATEMENT (SECOND) OF CONTRACTS § 318 cmt. c (1981) (“Delegation of performance is a normal and permissible incident of many types of contract The principal exceptions relate to contracts for personal services and to contracts for the exercise of personal skill or discretion.”). *See also id.* § 318 cmt. c, illus. 6 (“A contracts with B, a corporation, to sing three songs over the radio as part of an advertisement of B's product. A's performance is not delegable unless B assents.”).

20. *Id.* § 365(e)(2)(B).

gations are cancelled “whether or not such contract . . . prohibits or restricts assignment of rights”²¹

A different part of section 365 governs the cure of defaults. Cure is the price of assumption of an executory contract, and section 365(b) eliminates *ipso facto* matters from the concept of “cure,” which does not apply to a default that is a breach of a provision relating to

- (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
- (B) the commencement of a case under this title;
- (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or
- (D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease.²²

Taken in isolation, governance by section 365 of the *ipso facto* clause is temporally very limited. According to section 365(e)(1), termination or modification based on *ipso facto* rights is prohibited “at any time *after the commencement of the case*.”²³ Prior to the bankruptcy petition, section 365(e) has nothing to say about contract termination. Standing alone, section 365(e) indicates that a creditor who rushes a termination notice to a debtor just before the bankruptcy petition (based on, say, a default clause that turns on the debtor’s insolvency) escapes from the clutches of the bankruptcy trustee. Indeed, termination may be automatic upon insolvency without any notification to the debtor. By the time the bankruptcy petition is filed, the contract is already terminated.

Here is where section 541(c)(1) comes to the rescue. An executory contract is, of course, property of the estate that the trustee may use, sell, or lease under section 363. Suppose, however, that before bankruptcy, the creditor has already terminated the executory contract, an act entirely consistent with section 365(e)(1). Naturally, section 363(e) must be read in conjunction with section 541(c)(1). An executory contract is a prepetition property right of the debtor that becomes property of the estate upon the commencement of the case.²⁴ As a property right, section 541(c)(1) governs such a terminated contract:

[A]n interest of the debtor in property becomes property of the estate under subsection (a)(1),(a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—

- (A) that restricts or conditions transfer of such interest by the debtor; or
- (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on

21. *Id.* § 365(e)(2).

22. *Id.* § 365(b)(2).

23. *Id.* § 365(e)(1) (emphasis added).

24. *See id.* § 365(a).

the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.²⁵

Thus, the “terminated” contract hypothesized above enters the bankruptcy estate nevertheless by operation of section 541(c)(1). Once the executory contract is in the bankruptcy estate by this means, section 365(e) takes jurisdiction to prevent a postpetition termination or modification during the course of the case.

B. *Ipso Facto and Modification*

In its definition of “*ipso facto*,” the *Iberiabank* court gives as an example a clause that *terminates* an executory contract upon the debtor's insolvency.²⁶ But a termination clause is only an example. Section 541(c)(1) goes beyond this example to prohibit *any modification* triggered by an *ipso facto* event.²⁷

For example, in *Katzenstein v. VIII SV5556 Lender, LLC (In re Saint Vincent's Catholic Medical Centers of New York)*,²⁸ the only event of default with respect to a mortgage was the filing of a bankruptcy petition. The mortgage contract permitted the creditor to add a six million dollar “acceleration fee” by virtue of the bankruptcy.²⁹ Such a clause constitutes a *modification* of the contract “solely because of a provision in such contract or lease that is conditioned on . . . (B) the commencement of a case under this title.”³⁰ Any *change* in the contractual obligation of the nondebtor constitutes a prohibited *ipso facto* modification,³¹ although the *Saint Vincent* court would hold otherwise.³²

One very common *ipso facto* modification set forth in loan agreements is the triggering of a higher postdefault interest rate, to which I now turn.

C. *Postdefault Interest Rates*

In loan agreements, lenders have learned to add clauses insisting on higher postdefault interest rates. For example, in *In re General Growth Properties Inc.*,³³ a mortgage agreement made the voluntary commence-

25. *Id.* § 541(c)(1).

26. *Iberiabank v. Beneva 41-I, LLC*, 701 F.3d 916, 920 n.5 (11th Cir. 2012).

27. § 541(c)(1)(B).

28. 440 B.R. 587 (Bankr. S.D.N.Y. 2010).

29. *Id.* at 592.

30. § 365(e)(1).

31. In *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Serv. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010), a debtor had rights to collateral, but if the debtor filed for bankruptcy some other creditor was to take priority to that collateral. *Id.* at 410. The bankruptcy court ruled that the debtor's collateral came into the debtor's bankruptcy estate free and clear of the *ipso facto* modification of the debtor's priority right. *Id.* at 418.

32. See *infra* text accompanying notes 64–69.

33. 451 B.R. 323 (Bankr. S.D.N.Y. 2011).

ment of a bankruptcy case an event of default,³⁴ and further provided that upon any default, the lender was entitled to a three percent increase in the rate of interest owed on the balance of the unpaid principal.”³⁵ When such a lender is undersecured or unsecured, postdefault interest hikes such as the one in *General Growth* are not prejudicial to the unsecured creditors. When a lender is undersecured, Bankruptcy Code section 506(a)(1) requires that the lender’s secured claim be bifurcated into a perfectly secured and a perfectly unsecured claim.

The undersecured claim is not entitled to interest compensation, per the Supreme Court’s important ruling in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*³⁶ The unsecured portion of the claim is disentitled to postpetition interest by the workings of Bankruptcy Code sections 502(a) and (b), which provide that if a party in interest objects to a proof of claim, the court must determine the amount of such claim “as of the date of the filing of the petition.”³⁷ The timing of this determination guarantees that unsecured creditors get no postpetition interest.³⁸ To erase any doubt on that score, section 502(b)(2) prohibits the allowance of unsecured claims for “unmatured interest.”³⁹ In the case of a near-solvent Chapter 7 debtor, it may be noted that section 726(a)(5) authorizes a deeply subordinated distribution to “payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under [section 726(a)(1)-(4)]”⁴⁰ Payment of the legal rate precludes any claim of an undersecured creditor to postdefault contractual interest in the case of a near-solvent Chapter 7 debtor.

In contrast, oversecured creditors are entitled to pendency interest pursuant to section 506(b), which provides:

To the extent that an allowed secured claim is secured by property the value of which, after any recover 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 or State under which such claim arose.⁴¹

“Allowed secured claim” is a term of art that suggests that a proof of claim has been filed by⁴² or on behalf⁴³ of an oversecured creditors. In a Chapter 11 case, where these questions are most apt to arise,

34. *Id.* at 324.

35. *Id.*

36. 484 U.S. 365 (1988).

37. 11 U.S.C. § 502(b) (2012).

38. That interest stops accruing at the commencement of a bankruptcy proceeding is a rule of ancient lineage. John C. McCoid, II, *Pendency Interest in Bankruptcy*, 68 AM. BANKR. L.J. 1, 1 (1994); *Ex parte Bennet*, 26 Eng. Rep. 716, 717 (1743) (“Commissioners, after a man becomes bankrupt, compute interest upon debts no lower than the date of the commission, because it is a dead fund; and in such a shipwreck, if there is salvage of part to each person in this general loss, it is much as can be expected.”).

39. § 502(b)(2).

40. *Id.* § 726(a)(5).

41. *Id.* § 506(b).

42. *Id.* § 501(a).

[a] proof of claim . . . is deemed filed under section 501 . . . for any claim . . . that appears in the schedules filed under section 521(a)(1) or 1106(a)(2), except a claim . . . that is scheduled as disputed, contingent, or unliquidated.⁴⁴

An unexplored question is whether a secured creditor with no proof of claim or not covered by section 1111(a) is entitled to pendency interest. I merely note the issue and pass on, as typically oversecured creditors are organized to file proofs of claims and to monitor debtor compliance with section 1111(a).⁴⁵ Because of these restrictions on pendency interest, a claim for enhanced postdefault interest will arise only in the context of oversecured creditors who have allowed secured claims.

Let us examine quite carefully how property encumbered by a security interest enters the bankruptcy estate where the secured creditor claims a right to postdefault interest. We shall presuppose that, prior to the bankruptcy proceeding, the debtor owns real or personal property encumbered by a security interest where the creditor is oversecured. According to section 541(a):

The commencement of a case . . . creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsection (b) or (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case⁴⁶

This section suffices to bring the secured creditor's collateral into the bankruptcy estate. In the case of real property, many states insist that "legal" title is located in the mortgagee, in which case the debtor owns the equitable interest in the real property.⁴⁷ In the so-called lien states, title is located in the debtor, who is deemed to have a "legal" interest.⁴⁸ Either way, the property is deemed transferred into the bankruptcy estate by virtue of the commencement of the bankruptcy proceeding.⁴⁹ In personal property cases, Article 9 of the Uniform Commercial Code avoids the language of title, and so one would say the debtor has a legal interest in personal property encumbered by an Article 9 security interest.⁵⁰

Section 541(c)(1) regulates how such property, whether real or personal, comes into the bankruptcy estate. If we strip from section

43. *Id.* § 501(b)–(c).

44. *Id.* § 1111(a).

45. BANKRUPTCY SERVICE, LAWYERS EDITION §§ 24:322, 24:424 (2d ed. 2014).

46. § 541(a)(1).

47. *Commerce Bank v. Mountain View Vill., Inc.*, 5 F.3d 34, 38 (3d Cir. 1993).

48. *Citation Mortg., Ltd. v. Ormond Beach Assocs. Ltd. P'ship (In re Ormond Beach Assocs. Ltd. P'ship)*, 184 F.3d 143, 153 (2d Cir. 1999).

49. *See, e.g., id.* at 147.

50. Robert K. Weiler, *Basics of Creation and Perfection of Security Interests Under Article 9 of the Uniform Commercial Code*, BOUSQUET HOLSTEIN PLLC, (Sept. 2006), <http://bhlawpllc.com/wp-content/uploads/2014/04/CREATION-AND-PERFECTION-OF-SECURITY-INTERESTS-RKW1.pdf>.

541(c)(1) all reference to “termination” of a property interest and focus only on language referring to “modification,” we obtain:

an interest of the debtor in property becomes property of the estate under subsection (a)(1) . . . notwithstanding any provision in an agreement . . .

(B) that is conditioned on the insolvency or financial condition of the debtor or on appointment of or taking possession by a trustee in a case under this title . . . and that effects . . . a . . . , modification . . . of the debtor’s interest in property.⁵¹

Thus, the postdefault interest rate results from an agreement that is “conditioned on the insolvency or financial condition of the debtor,” etc.⁵² The debtor’s interest in the encumbered property comes into the bankruptcy estate “notwithstanding any provision” in such a condition.⁵³

To prove my case, I must show that the postdefault interest provision modifies “the debtor’s interest in property.”⁵⁴ This can be done by carefully considering what a debtor’s interest in property is when that property is encumbered by an oversecured creditor’s mortgage. First of all, a debtor has a right to possess the property (if there has been no repossession by the creditor) and to alienate the equity interest in the property (subject to the lien).⁵⁵ This much passes to the trustee. Second, the trustee has the right to receive the cash surplus in case the senior lien is foreclosed.⁵⁶

The right of a debtor to receive the surplus from a foreclosure sale is modified by a postdefault interest provision and is therefore struck down by section 541(c)(1).⁵⁷ That the debtor’s right to a surplus is a property right in the thing that is encumbered by the lien is confirmed by the Supreme Court in *United States v. Whiting Pools, Inc.*⁵⁸ The case involved the repossession of chemicals from a business debtor pursuant to a tax lien.⁵⁹ Here is what the Supreme Court said about this tax lien:

The Service’s interest in seized property is its lien on that property. The Internal Revenue Code’s levy and seizure provisions are special procedural devices available to the IRS to protect and satisfy its liens, and are analogous to the remedies available to private secured creditors. They are provisional remedies that do not determine the Service’s rights to the seized property, but merely bring the property into the Service’s legal custody. *At no point does the Service’s interest in the property exceed the value of the lien.* Owner-

51. § 541(c)(1)(B).

52. *Id.*

53. *Id.*

54. *Id.*

55. WILLIAM D. HAWKLAND ET AL., HAWKLAND’S UNIFORM COMMERCIAL CODE SERIES § 9-311:1 n.17 (2014).

56. *S. & Assocs., P.C. v. Ford*, No. 4:07–CV–2021 (JCH), 2008 WL 2906857, at *2 (E.D. Mo. July 24, 2008).

57. *E. C. Bishop & Son, Inc. v. Internal Revenue Serv. (In re E. C. Bishop & Son, Inc.)*, 19 B.R. 633, 635 (W.D. Mo. 1982).

58. 462 U.S. 198, 211 (1983).

59. *Id.* at 200.

ship of the property is transferred only when the property is sold to a bona fide purchaser at a tax sale. In fact, the tax sale provision itself refers to the debtor as the owner of the property after the seizure but prior to the sale. Until such a sale takes place, the property remains the debtor's and thus is subject to the turnover requirement of § 542(a).⁶⁰

According to the Supreme Court, the “value of the lien” held by the IRS limits the IRS's interest in the thing “owned” by the debtor. “Value of the lien” refers to the claim to back taxes plus interest and penalties as authorized by the Internal Revenue Code.⁶¹ Translating this to the realm of liens created by contract, a secured creditor's lien is limited to the amount of the secured claim, as regulated by section 542(c)(1). Correlatively, whatever the secured creditor does *not* have is a “debtor's interest” in the property, within the meaning of section 541(a)(1). Thus, the *ipso facto* limitation on the lien has the complementary effect of increasing what is left over *after* the lien is accounted for. Accordingly, the encumbered property enters the bankruptcy estate “notwithstanding” the *ipso facto* enhancement of the creditor's lien. Section 541(c)(1) purges a mortgage agreement of a postdefault interest clause triggered by an *ipso facto* event.

To approach the matter from a slightly different angle, one can say that a right to proceeds of a thing in case of sale is a right to the thing itself. Under Article 9, “a security interest attaches to any identifiable proceeds of collateral.”⁶² Therefore, it is natural to think that the right to proceeds is an important incident to having a right in the original collateral. So, complementarily, a debtor with an “ownership” right, as the Supreme Court calls it (i.e., “debtor equity”), has an incidental right to proceeds in case there is a surplus after a foreclosure sale of this ownership right.⁶³ Therefore, any *ipso facto* clause that increases the secured party's rights to proceeds limits “the debtor's interest in property” within the meaning of section 541(c)(1)(B). In short, section 541(c)(1)(B) cleanses collateral of contractual postdefault interest, if it indeed stems from *ipso facto* contract provisions.

From this it follows that whenever the only default asserted by a secured creditor is an *ipso facto* default the collateral enters the bankruptcy estate free and clear of the clause that calls for higher default interest.⁶⁴

60. *Id.* at 210–11 (emphasis added) (citations omitted).

61. Frank S. Alexander, *Tax Liens, Tax Sales, and Due Process*, 75 IND. L.J. 747, 803–04 (2000).

62. U.C.C. § 9-315(a)(2) (2010).

63. In Article 9, the debtor's right to a surplus is described in section 9-615(d)(1):

If the security interest under which a disposition is made secures payment . . . of an obligation, after making the payments and applications required by subsection (a) and permitted by subsection (c):

(1) unless subsection (a)(4) requires the secured party to apply or pay over cash proceeds to a consignor, the secured party shall account to and pay a debtor for any surplus . . .

U.C.C. § 9-615(d)(1) (2010).

64. See *In re W.R. Grace & Co.*, 475 B.R. 34, 152–54 (D. Del. 2012), *aff'd*, 729 F.3d 311 (3d Cir. 2013), for a case holding that *ipso facto* clauses are erased, not on a reading of section 541(c)(1), but

Therefore, no matter what the context, the award of higher interest in this context is never justified.

These premises, however, were rejected by the court in *Katzensteyn v. VIII SV556 Lender, LLC (In re Saint Vincent's Catholic Medical Centers of New York)*.⁶⁵ In that case, the creditor had the right to add a “fee” to the amount of principal and interest due in case of bankruptcy.⁶⁶ The court allowed this fee, even though it was a purely *ipso facto* term.⁶⁷ According to the court, section 541(c)(1)(B) “does not invalidate the clause including commencing a bankruptcy among the events of the default. The collateral unquestionably came into the bankruptcy estate. . . . The question is how much the Creditor may recover . . . , not whether the collateral is property of the estate.”⁶⁸ This conclusion is simply an example of the erroneous assumption that *ipso facto* clauses relate to termination of a debtor’s interest in property—not to the modification of it.⁶⁹ In effect, the court reads the antimodification language in section 541(c)(1) out of the Bankruptcy Code—an interpretive *faux pas*.⁷⁰

In a reverse double spin on this error, the indenture in *U.S. Bank Trust National Assn. v. AMR Corp. (In re AMR Corp.)*⁷¹ made the filing of a bankruptcy petition an *ipso facto* event of default and acceleration. This allowed the debtor to prepay on favorable terms. The indenture trustee then took the position that, even though the *ipso facto* clause favored the debtor, all *ipso facto* clauses are void.⁷² It seems plausible to think that prodebtor *ipso facto* clauses can be embraced by the debtor, since the purpose of invalidating such clauses is to protect the unsecured creditors; where the unsecured creditors are helped by such a clause, there would seem to be no reason why the clause could not be asserted by a debtor against a creditor. The court, however, chose to rule that section 541(c)(1) does not bar *ipso facto* modifications—only *ipso facto* terminations.⁷³

III. DEFAULT INTEREST NOT BASED ON *IPSO FACTO* EVENTS

An *ipso facto* clause is described in section 541(c)(1)(B) as one “that is conditioned on the insolvency or financial condition of the debt-

from a general penumbra surrounding sections 541(c) and 365(e)(1) generally. In my view, however, this result can be grounded squarely in the text of section 541(c)(1).

65. 440 B.R. 587, 601–02 (Bankr. S.D.N.Y. 2010).

66. *Id.* at 595, 600.

67. *Id.* at 601.

68. *Id.* at 601–02.

69. A challenging case is *In re Frank's Nursery & Crafts, Inc.*, No. 04-15826 (PCB), 2006 Bankr. LEXIS 1964, at *7, 15-16 (Bankr. S.D.N.Y. May 8, 2006). In this case a secured creditor had the right to enhance its secured claim if the debtor filed for bankruptcy. The right to enhancement was stipulated in a prior confirmed Chapter 11 plan. The court, therefore, decided that the earlier plan deserved *res judicata* respect, and so the *ipso facto* clause was permitted in the second bankruptcy.

70. *United States v. Nordic Vill., Inc.*, 503 U.S. 30, 35 (1992).

71. 730 F.3d 88, 112 (2d Cir. 2013).

72. *Id.* at 107.

73. *Id.* at 106.

or or on appointment of or taking possession by a trustee in a case under this title or custodian before such commencement . . .”⁷⁴ The set of possible defaults, however, will invariably exceed these *ipso facto* events. For example, a loan agreement will certainly make failure to pay debt service an event of default (I will refer to this as a monetary default). Failure to make a timely payment is something in which negligent solvent debtors occasionally indulge.⁷⁵ Does the Bankruptcy Code prohibit a postdefault interest rate as a result of a monetary default?

Here the answer must be no. Failure to make a required interest payment cannot be fairly viewed as an *ipso facto* event, as it is quite unrelated to the conditions described in section 541(c)(1)(B). Default clauses are sometimes unconditional and automatic.⁷⁶ Sometimes they require notice to the debtor that default is being declared.

Suppose a default clause contains both a standard monetary default and *ipso facto* events, all of which are automatically triggered without the creditor having to serve a default notice. Meanwhile, during insolvency, the debtor misses an interest payment. One would expect that the increased rate could not be sustained on the basis of the *ipso facto* criteria, but it could be maintained quite independently on the basis of the interest rate default. Similarly, where default does not exist until the creditor serves notice of it on the debtor, and where the default clause contains *ipso facto* criteria as well as standard monetary default, a creditor who serves the required notice and who relies on the monetary default should be able to trigger the default interest provision with interference of the Bankruptcy Code.

The distinction between monetary defaults and *ipso facto* defaults would play out as follows. Where a prepetition monetary default has occurred, postdefault interest accrues, if permitted under state law.⁷⁷ But, once the bankruptcy proceeding commences, the law of section 506(b) applies to govern the interest rate.⁷⁸ In contrast, when the only default is of the *ipso facto* variety, since collateral enters the bankruptcy estate free and clear of *ipso facto* clauses in contracts, accrued *ipso facto* interest is canceled, and the secured creditor cannot claim such interest, even if it has accrued prior to bankruptcy.

While this distinction between monetary defaults and *ipso facto* defaults may seem to harm the unsecured creditors of a debtor who indulges in both kinds of defaults, two factors significantly mitigate the harm that unsecured creditors will face from a postdefault rate unconnected with an *ipso facto* event. First, entitlement to pendency interest is limited by section 506(b), which, if properly interpreted, excludes or at least does not require the contractual pendency rate. Second, a loan agreement that

74. 11 U.S.C. § 541(c)(1)(B) (2012).

75. See *Graf v. Hope Bldg. Corp.*, 171 N.E. 884, 885 (N.Y. 1930).

76. E.g., *In re Sagamore Partners, Ltd.*, 512 B.R. 296, 301 (S.D. Fla. 2014); Kleinhaus & Zuckerman, *supra* note 8, at 193.

77. See *In re Schatz*, 426 B.R. 24, 28 (Bankr. D.N.H. 2009).

78. *Id.*

is in default can be reinstated at the original predefault rate, once the past non-*ipso facto* defaults have been cured.

A. *Interest Under Section 506(b)*

Section 506(b) provides that, to the extent that a secured creditor enjoys an equity cushion in the collateral:

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.⁷⁹

Notice that, according to section 506(b), the *contract* governs for fees and costs. Thus, if the contract does not provide for fees, costs, or charges, they cannot be awarded.⁸⁰ But does the contract also govern the rate of interest a secured party may collect?

In *United States v. Ron Pair Enterprises, Inc.*,⁸¹ the Supreme Court firmly answered “no.” An important comma after “interest on such claim” separates interest compensation from the security agreement.⁸² The Supreme Court rested heavily on this comma in holding that the contract is irrelevant to an oversecured creditor’s right to pendency interest.⁸³ This ruling won for statutory lienors the right to pendency interest, when such lienors have no contractual relation with the debtor.⁸⁴ According to the Supreme Court:

The phrase “interest on such claim” is set aside by commas and separated from the reference to fees, costs, and charges by the conjunctive words “and any.” As a result, the phrase “interest on such claim” stands independent of the language that follows. “Interest on such claim” is not part of the list made up of “fees, costs, or charges,” nor is it joined to the following clause so that the final “provided for under the agreement” modifies it as well. “The language and punctuation Congress used cannot be read in any other way. By the plain language of the statute, the two types of recovery are distinct.”⁸⁵

79. § 506(b).

80. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 235, 241 (1989).

81. *Id.* at 241.

82. *Id.* at 241–42.

83. *Id.* at 241.

84. *Id.*

85. 489 U.S. at 242. Two pre-*Ron Pair* cases reach this conclusion. *In re Marx*, 11 B.R. 819, 821 (Bankr. S.D. Ohio 1981) (cure case in which it was assumed that section 506(b) governed); *In re Minguey*, 10 B.R. 806, 808–09 (Bankr. W.D. Wis. 1981). Before *Ron Pair*, a great many courts assumed that the contract rate was mandatory under section 506(b). That is, they assumed that the oversecured party must get the interest “provided for under the agreement . . .” See *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.)*, 793 F.2d 1380, 1407 (5th Cir. 1986), *aff’d en banc*, 808 F.2d 363 (5th Cir.1987), *aff’d*, 484 U.S. 365 (1988); *Cnty. Bank v. Torcise (In re Torcise)*, 187 B.R. 18, 23 (S.D. Fla. 1995); *Schlag v. Mendelson (In re Schlag)*, 60 B.R. 749, 751 (Bankr. W.D. Pa. 1986).

In other words, the right to interest is *unconnected* to the contract, and from this it follows that the contract rate need not be used, *even if* there is a contract.⁸⁶ The proper rate of interest is open to choice.⁸⁷

The Supreme Court soon confirmed this interpretation in *Rake v. Wade*.⁸⁸ The context of *Rake* is confusing, but must be understood to appreciate its rejection of the contract interest for section 506(b) cases.⁸⁹ In *Rake*, a Chapter 13 debtor wished to cure and reinstate a mortgage agreement, as is authorized under Bankruptcy Code section 1322(b)(5).⁹⁰ Such reinstatement overrides the rule in section 1322(b)(2) against modifying home mortgages and, in addition, permits the reinstated debt to be paid over time beyond the life of a Chapter 13 plan, which is otherwise limited to a maximum of five years.⁹¹ The debtor proposed to cure defaults by paying the amounts past due within “a reasonable time,” as section 1322(b)(5) authorizes.⁹² The debtor proposed to pay no interest on these past defaults, covering the period between the default and the calculation of the price of cure.⁹³ Several appellate opinions required interest on these defaults only if the contract called for it.⁹⁴ The creditor, however, was oversecured, and so the creditor insisted that section 506(b) guaranteed it pendency interest on the cure claim, because the cure claim was part of the secured claim.⁹⁵

Even though the contract did not call for interest on interest, the Supreme Court upheld the idea that section 506(b) requires it as part of the cure.⁹⁶ In so doing, it relied on *Ron Pair’s* principle that section 506(b) interest entitlements are unrelated to the contract.⁹⁷ Accordingly, the absence of a contractual provision did not excuse the debtor from paying interest on arrears (including interest on interest past due) as part

86. *In re Nixon*, 404 Fed. App’x 575, 578–79 (3d Cir. 2010).

87. See *Key Bank Natl. Ass’n v. Milham (In re Milham)*, 141 F.3d 420, 423 (2d Cir. 1998) (per curiam), *cert. denied*, 525 U.S. 872 (1998); *Shearson Lehman Mortg. Corp. v. Laguna (In re Laguna)*, 944 F.2d 542, 544 (9th Cir. 1991) (cure case in which section 506(b) was assumed to govern), *cert. denied*, 503 U.S. 966 (1992); *In re Johnson*, 184 B.R. 570, 572 (Bankr. D. Minn. 1995) (assuming the choice was between pre- or post-default rate stipulated in contract, in a case where a mature secured claim was “cured” by being paid in full); *Fischer Enters., Inc. v. Geremia (In re Kalian)*, 178 B.R. 308, 312 (Bankr. D.R.I. 1995); *Warehouse Home Furnishings Distribs., Inc. v. Gladdin (In re Gladdin)*, 107 B.R. 803, 805–06 (Bankr. M.D. Ga. 1989) (nevertheless imposing the contract rate as a matter of prudence). For a contrary case imposing a thirty-six percent postdefault rate of interest provided for by the contract, see *Hepner v. PWP Golden Eagle Tree, LLC (In re K & J Props., Inc.)*, 338 B.R. 450, 460 (Bankr. D. Colo. 2005).

88. 508 U.S. 464, 468 (1993).

89. *Id.* at 472.

90. *Id.* at 466.

91. 11 U.S.C. § 1322(d) (2012).

92. *Rake*, 508 U.S. at 469 n.5 (quoting section 1322(b)(5)).

93. *Id.* at 470.

94. *E.g., Landmark Fin. Servs. v. Hall*, 918 F.2d 1150, 1155 (4th Cir. 1990).

95. *Rake*, 508 U.S. at 466.

96. *Id.* at 472.

97. *Id.* at 468 (citing *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989)).

of the price of cure.⁹⁸ The source of the mandate to pay pendency interest was that part of section 506(b) which precedes the *Ron Pair* comma.⁹⁹

According to the interpretation offered in these two Supreme Court opinions, the contract does not necessarily establish the proper interest rate under section 506(b) for oversecured creditors. What, then, should be the criterion of choice?

There are three possibilities. First, a court may impose a market rate of interest. Second, the court might impose a statutory rate, such as the rate that is imposed to enhance a money judgment that is not paid. Such a choice is imposed on unsecured creditors seeking a distribution under section 726(a)(5). Third, the contract rate could be imposed, even though section 506(b) does not require this.

1. *The Market Rate*

The choice of a market rate was upheld in *Key Bank N.A. v. Milham (In re Milham)*,¹⁰⁰ where a Chapter 13 debtor proposed to pay an oversecured creditor the market rate of interest (not the contract rate) for the period after bankruptcy, but before the confirmation of the plan. The secured party opposed confirmation claiming that section 506(b) entitled it to the contract rate, not the market rate.¹⁰¹ The Second Circuit disagreed:

section 506(b) does not say that the oversecured creditor collects pendency interest at the contractual rate. In *United States v. Ron Pair Enterprises, Inc.*, the Supreme Court held that the phrase “provided for under the agreement under which such claims arose” does not modify the phrase “interest on such claim.” Unlike prepetition interest, pendency interest is not based upon contract. The appropriate rate of pendency interest is therefore within the limited discretion of the court. Most courts have awarded pendency interest at the contractual rate, but nevertheless, however widespread this practice may be, it does not reflect an entitlement to interest at the contractual rate.¹⁰²

Milham therefore stands for the proposition that the market rate might be chosen instead of the contract rate.

A market rate of interest has three components: (1) a “real” rate or opportunity cost (competitively determined); (2) an inflationary component; and (3) a risk premium.¹⁰³ Prior to the Supreme Court’s opinion in

98. *Id.* at 474–75.

99. *Id.* at 468 (citing *Ron Pair*, 489 U.S. at 241).

100. 141 F.3d 420, 424 (2d Cir. 1998).

101. *Id.*

102. *Id.* at 423 (citations omitted) (citing Bankruptcy Code section 506(b)).

103. *In re Valuation Proceedings under Sections 303(c) & 306 of the Reg’l Rail Reorg. Act of 1973*, 531 F. Supp. 1191, 1231 (Regional Rail Reorg. Ct. 1981). Properly speaking, a market right might also include profit, which stems from the monopoly power a lender has over a borrower, which might stem from superior knowledge that the actual risk is less than the market perception. Thus, a specific creditor who charges the market rate might to enjoy a supracompetitive profit. David Gray Carlson, *Debt Collection as Rent Seeking*, 79 MINN. L. REV. 817, 823–28 (1995). It is an error to confuse oppor-

Till v. SCS Credit Corp.,¹⁰⁴ there were dozens of formulas offered by the courts to discover the market rate of interest.¹⁰⁵ For better or worse, the plurality opinion in *Till* now provides simple guidance which courts since *Till* have faithfully followed.¹⁰⁶ *Till* involved a reading of section 1325(a)(5)(B) which applies to secured creditors when a debtor wishes to retain collateral encumbered by a lien.¹⁰⁷ According to section 1325(a)(5)(B)(ii), a secured creditor must receive “the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim [that] is not less than the allowed amount of such claim”¹⁰⁸ This is Chapter 13’s “cram down” provision, in which a secured party is forced to take plan provisions in compensation for losing its right to enforce the lien after default.

The word “value” signals a discount rate, which is the inverse of the interest rate to which oversecured creditors are entitled under section 506(b).¹⁰⁹ All courts agree that the cram down provision invokes a market rate.¹¹⁰ The difficulty is how to determine the market rate, which is properly neither an objective nor a subjective but rather a subjunctive matter. As with any value, reference must be made to hypothetical world in which a buyer and seller trade commodities. In effect, a court seeking a market rate in a bankruptcy case must ask what creditors would charge a specific debtor in a “what-if” world that does not actually exist.

In *Till*, the Seventh Circuit ruled that the contract rate was presumptively a proxy for the market rate.¹¹¹ A plurality of the Supreme

tunity cost with “profit,” as was done in Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 T. MARSHALL L. REV. 241, 261 (1994). Opportunity cost is that which must be covered to draw a producer into the market when the competitive price is being charged. If opportunity cost cannot be covered, a self-interested producer will flee the market. Therefore, opportunity cost is a “cost” just as much as risk is. Profit, on the other hand, is price minus cost (including opportunity cost). When profit exists, producers who are already obtaining opportunity cost elsewhere will be drawn to the market where profit exists, thereby driving the price down to the competitive level.

104. 541 U.S. 465, 474 (2004).

105. 2 GRANT GILMORE & DAVID GRAY CARLSON, GILMORE AND CARLSON ON SECURED LENDING: CLAIMS IN BANKRUPTCY § 31.03 (2d ed. 2000) (identifying forty-three different approaches); Daniel R. Wong, *Chapter 11 Bankruptcy and Cramdowns: Adopting a Contract Rate Approach*, 106 NW. U.L. REV. 1927, 1935–40 (2012).

106. *In re Linda Vista Cinemas*, L.L.C., 442 B.R. 724, 750 (Bankr. D. Ariz. 2010).

107. *Till*, 541 U.S. at 473–74.

108. 11 U.S.C. § 1325(a)(5)(B)(ii) (2012).

109. *CoreStates Bank, N.A. v. United Chem. Techs., Inc.*, 202 B.R. 33, 52 (E.D. Pa. 1996).

110. David G. Epstein, *Don't Go and Something Rash About Cram Down Interest Rates*, 49 ALA. L. REV. 435, 443–44 (1998).

111. *See In re Till*, 301 F.3d 583, 592–93 (2002) (en banc). The Seventh Circuit had adopted the rule formulated by *Gen. Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 70–71 (3d Cir. 1993) (“In the absence of a stipulation regarding the creditor’s current rate for a loan of similar character, amount and duration, we believe it would be appropriate for bankruptcy courts to accept a plan utilizing the contract rate if the creditor fails to come forward with persuasive evidence that its current rate is in excess of the contract rate. Conversely, utilizing the same rebuttable presumption approach, if a debtor proposes a plan with a rate less than the contract rate, it would be appropriate for a bankruptcy court to require the debtor to come forward with some evidence that the creditor’s current rate is less than the contract rate.”).

Court, however, implied that the choice of the contract rate was inappropriately subjective rather than objective (i.e., subjunctive):¹¹²

[A]lthough § 1325(a)(5)(B) entitles the creditor to property whose present value objectively equals or exceeds the value of the collateral, it does not require that the terms of the cram down loan match the terms to which the debtor and creditor agreed prebankruptcy, nor does it require that cram down terms make the creditor subjectively indifferent between present foreclosure and future payment. Indeed, the very idea of a “cram down” loan *precludes* the latter result: by definition, a creditor forced to accept such a loan would prefer instead to foreclose. Thus a court choosing a cram down interest rate need not consider the creditor’s individual circumstances, such as its prebankruptcy dealings with the debtor or the alternative loans it could make if permitted to foreclose. Rather the court should aim to treat similarly situated creditors similarly, and to ensure that an objective economic analysis would suggest the debtor’s interest payments will adequately compensate all such creditors for the time value of their money and the risk of default.¹¹³

The solution the *Till* plurality upheld was imposition of a prime rate of interest coupled with a risk enhancement. It also suggested in Chapter 11 cases bankruptcy courts might “ask what rate an efficient market [for debtor-in-possession financing] would produce.”¹¹⁴ Since *Till*, this has been the course that courts have followed in determining the market rate of interest in cram down cases.¹¹⁵

2. *The Legal Rate of Interest*

A second option is for the choice of the legal rate of interest, defined as the federal statutory rate pursuant to 28 U.S.C. § 1961(a).¹¹⁶ The choice of a statutory rate was made by Judge Leif Clark in *In re Laymon*.¹¹⁷ Judge Clark took the strong position that *Ron Pair* disenfranchised the contract rate under section 506(b).¹¹⁸ But he showed no patience for subjunctive counterfactual speculation about what would have happened absent bankruptcy.¹¹⁹ Instead, he thought that the federal legal

112. 541 U.S. at 476.

113. *Id.* at 476–77.

114. *Id.* at 476 n.14. See generally Wong, *supra* note 105, at 1948–49 (defining “efficient markets”).

115. *Id.* at 1952.

116. Onink v. Cardelucci (*In re Cardelucci*), 285 F.3d 1231, 1234 (9th Cir. 2002).

117. 117 B.R. 856 (Bankr. W.D. Tex. 1990); see Bradford v. Crozier (*In re Laymon*), 958 F.2d 72, 74 (5th Cir. 1992), *cert. denied sub nom.*, Crozier v. Bradford, 506 U.S. 917 (1992).

118. *In re Laymon*, 117 B.R. at 858–859.

119. Judge Clark wrote:

The court recognizes that one alternative analysis might be offered to support an award of contract interest to the oversecured creditor, on the theory that the equity in the collateral outside bankruptcy would take subject to that contract interest claim. The result, would go the logic, should be no different in bankruptcy.

This argument does not account for the operation of Section 502, however. All creditors, including oversecured creditors, are deemed to have an allowed claim as of the bankruptcy filing which is the functional equivalent of a *federal judgment* against the estate’s assets.

Id. at 864 (emphasis in original).

rate should always apply, because the secured party's claim in bankruptcy is analogous to a judgment in a federal court.¹²⁰ This principle was inspired by section 726(a)(5), one of the provisions governing the distribution of the bankrupt estate to the general creditors.¹²¹ According to section 726(a)(5), if all the creditors have been paid, they are further entitled to interest compensation at the legal rate out of the surplus.¹²² This rejection of the contract rate reveals a bankruptcy policy of equal treatment as extended to interest rates, including interest rates under section 506(b).¹²³ Furthermore, a policy of national uniformity made the federal legal rate superior to various state legal rates.¹²⁴ This view was overruled by the Fifth Circuit Court of Appeals, however, which imposed the contract rate of interest instead.¹²⁵ Since *Laymon*, there seems to be no instances of a court choosing the statutory rate of interest.

3. *The Contract Rate of Interest*

In spite of *Ron Pair*, courts still seem to favor the contract rate for its own sake, not as a proxy for the market rate, in spite of the two Supreme Court pronouncements on the matter. The most recent statement to this effect is *In re SW Boston Hotel Venture, LLC*,¹²⁶ where the First Circuit Court of Appeals applied a postdefault penalty rate as the appropriate rate for section 506(b). The *SW* court accurately noted that section 506(b)

does not specify how to compute post-petition interest. The Supreme Court, construing § 506(b), has held that the phrase “provided for under the agreement or State statute under which such claim arose” modifies only “reasonable fees, costs, or charges,” and not “interest on such claim.” Thus, the statutory language does not dictate that bankruptcy courts look to the applicable contract provisions, if any, when computing post-petition interest.¹²⁷

Yet despite this accurate observation, the *SW* court went on to note that courts are largely in agreement that, although the “appropriate rate of pendency interest is . . . within the limited discretion of the court,” where the parties have contractually agreed to interest

120. *Id.*

121. *Id.* at 859–60.

122. *Id.* at 860–61.

123. According to Judge Clark:

There is no good reason why one unsecured creditor should receive a greater share of the Section 726(a)(5) “pie” solely by virtue of its *prepetition* contract interest rate when the rationale for paying interest under Section 726(a)(5) has nothing to do with the *prepetition* contracts of the debtor.

We thus learn from this analysis the third basic principle which should inform our decisionmaking on the issue at hand: Postpetition interest awards should be consistent with the principle of equitable, ratable distribution of estate assets to estate creditors.

Id. at 861.

124. *Id.* at 862; *see also In re Landing Assocs., Ltd.*, 122 B.R. 288, 297 (Bankr. W.D. Texas 1990).

125. *Bradford v. Crozier (In re Laymon)*, 958 F.2d 72, 74 (5th Cir. 1992), *cert. denied sub nom.*, *Crozier v. Bradford*, 506 U.S. 917 (1992).

126. 748 F.3d 393 (1st Cir. 2014).

127. *Id.* at 413 (citing *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989)).

terms, those terms should presumptively apply so long as they are enforceable under state law and equitable considerations do not dictate otherwise.¹²⁸

I think this presumption in favor of the contract rate contradicts the spirit, if not the letter, of what the Supreme Court has said about section 506(b). Interest is to be awarded, but it cannot be just because the contract says so. Therefore, the presumption that the contract rate of interest should apply is ungrounded and arbitrary, if based only on the contract as such. A contract rate might be chosen as a proxy for a market rate, but the *SW* court, in upholding a postdefault interest penalty, was clearly not using the contract as a proxy for a compensatory market rate of interest.

This presumption that the contract governs has been favored on the theory that, in the case of any ambiguity, the Supreme Court generally requires the continuation of pre-Code law.¹²⁹ The weight of pre-Code practice favored the contract rate over the market or legal rate.¹³⁰ On this view, the comma in section 506(b) makes contracts irrelevant for tax lien creditors, but when contractual lien creditors exist, the comma suddenly loses its virility in separating the interest rate from the contract.

Significantly, the Supreme Court in *Ron Pair*¹³¹ went out of its way to emphasize that section 506(b) was intended to override pre-Code practice with regard to distinguishing between consensually created liens and statutory liens.¹³²

128. *Id.* (quoting *Key Bank Nat'l Ass'n v. Milham* (*In re Milham*), 141 F.3d 420, 423 (2d Cir. 1998)). For the proposition in the text, the *SW* court cites *Gen. Elec. Capital Corp. v. Future Media Prods. Inc.*, 536 F.3d 969, 974 (9th Cir. 2008) (adopting the rule “adopted by the majority of federal courts” that the “bankruptcy court should apply a presumption of allowability for the contracted for default rate, provided that the rate is not unenforceable under applicable nonbankruptcy law”) (internal quotation marks omitted); *In re Terry Ltd. P'ship*, 27 F.3d 241, 243 (7th Cir. 1994) (“What emerges from the post-Ron Pair decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations.”); 4 COLLIER ON BANKRUPTCY ¶ 506.04[2][b] (stating that interest, including allowance of contractual default rate and compounding, should be determined by reference to applicable nonbankruptcy law). The *SW* court goes on to say:

As the *General Electric Capital* court noted, enforcing the contract is consistent with the general premise that “creditors’ entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor’s obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.” 536 F.3d at 973 (alteration omitted) (quoting *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Electric Co.*, 549 U.S. 443, 450 (2007)) (internal quotation marks omitted); see also *In Re Lapiana*, 909 F.2d 221, 223 (7th Cir. 1990) (“Bankruptcy, despite its equity pedigree, is a procedure for enforcing pre-bankruptcy entitlements under specified terms and conditions rather than a flight of redistributive fancy . . .”).

748 F.3d at 413.

129. *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992).

130. *Bradford v. Crozier* (*In re Laymon*), 958 F.2d 72, 74 (5th Cir. 1992), cert. denied sub nom., *Crozier v. Bradford*, 506 U.S. 917 (1992).

131. 489 U.S. 235 (1989).

132. According to the *Ron Pair* Court:

Initially, it is worth recalling that Congress worked on the formulation of the Code for nearly a decade. It was intended to modernize the bankruptcy laws, and as a result made significant changes in both the substantive and procedural laws of bankruptcy. In particular, Congress intended “significant changes from current law in . . . the treatment of secured creditors and secured claims.” In such a substantial overhaul of the system, it is not appropriate or realistic to expect Congress to have explained with particularity each step it took. Rather, as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.

The *Ron Pair* Court invested some energy in discussing when pre-Code practice was relevant to interpretation of the modern Bankruptcy Code.¹³³ It explained that pre-Code practice had played a role in two previous Supreme Court cases.¹³⁴ In the first of the cases, pre-Code practice was mentioned but played no central role in the decision. “To put it simply, we looked to pre-Code practice for interpretive assistance, because it appeared that a literal application of the statute would be ‘demonstrably at odds with the intention of its drafters.’”¹³⁵ In the second case, involving discharge of criminally imposed restitution, the *Ron Pair* court said:

But in determining that Congress had not intended to depart from pre-Code practice in this regard, we did not rely on a pale presumption to that effect. We concluded that the pre-Code practice had been animated by a “deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings,” which has its source in the basic principle of our federalism that “the States’ interest in administering their criminal justice systems free from federal interference is one of the most powerful considerations that should influence a court considering equitable types of relief.”¹³⁶

Whatever the case was for criminal restitution fines, the interpretation of section 506(b) was another matter, the *Ron Pair* court thought. In short, section 506(b) was intended to wipe the slate clean of pre-Code practice.¹³⁷ Accordingly, it is inappropriate for post-*Ron Pair* courts to say precisely otherwise.

If the discretion of the court is “limited”¹³⁸ and not mandated by the contract, the only plausible principle guiding the use of this discretion is a market rate of interest. In support of that proposition, reference can be once again made to *Rake v. Wade*.¹³⁹ In *Rake*, a Chapter 13 plan purported to reinstate a mortgage agreement going forward and curing defaults looking backward.¹⁴⁰ The Supreme Court ruled that section 506(b) applied to guarantee pendency interest on the cure claim for the period

Id. at 240–41 (citations omitted) (quoting H. R. Rep. No. 95-595, at 180 (1977)).

133. *Id.* at 244.

134. *Kelly v. Robinson*, 479 U.S. 36, 36 (1986); *Midlantic Nat’l Bank v. New Jersey Dep’t of Envtl. Prot.*, 474 U.S. 494, 494 (1986).

135. 489 U.S. at 244 (citations omitted).

136. *Id.* at 244–45 (quoting *Kelly*, 479 U.S. at 45–46).

137. For the exact opposite view, *Bradford v. Crozier (In re Laymon)*, 958 F.2d 72, 75 (5th Cir. 1992), *cert. denied sub nom.*, *Crozier v. Bradford*, 506 U.S. 917 (1992). (“[W]e must conclude that Congress did not intend for § 506(b) of the Code to effect a major change in pre-Code practice concerning the rate of interest applied under the section.”) The *Laymon* court, however, would not accept the postdefault rate, which was eight percent higher than the predefault rate. Rather, it remanded with instructions for the lower court to determine whether the higher postdefault rate was equitable. *Id.*; see also *In re Terry Ltd. P’ship*, 27 F.3d 241, 243 (7th Cir. 1994) (*Ron Pair* “does not render the contracted-for default rate irrelevant . . . What emerges from post-*Ron Pair* decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations.”).

138. *In re SW Boston Hotel Venture, LLC*, 748 F.3d 393, 413 (1st Cir. 2014).

139. 508 U.S. 464 (1993).

140. *Id.* at 464–65.

prior to confirmation.¹⁴¹ As for the period after confirmation, the cram down provision guaranteed interest.¹⁴² Cram down interest¹⁴³ is clearly at the market rate, as that is determined by a bankruptcy court.¹⁴⁴ So, one sees *Rake* insisting upon a continuity between pendency interest under section 506(b) and cram down interest under section 1325(a)(5)(b)(ii). In support of this intended continuity between pendency interest and cram down interest is the following passage from *Till v. SCS Credit Corp.*: “[w]e think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions.”¹⁴⁵

If this is what Congress intended within cram down, why should we imagine Congress disfavored a unified rule for pendency interest?

The continuity between pendency interest and the cram down interest rate implies that bankruptcy courts are obliged to find a market rate for the purpose of section 506(b), borrowing from the *Till* analysis for cram down interest. Choice of the predefault rate of interest might be defended as a proxy for the market rate, but choice of the contractual postdefault interest rate could very rarely if ever be so defended.

One more Supreme Court opinion bears on the interpretation of section 506(b). In *Vanston Bondholders Protective Committee v. Green*,¹⁴⁶ a precedent relied upon in *United States v. Ron Pair Enterprises, Inc.*,¹⁴⁷ a debtor had been current on interest under a bond indenture at the time an equity receivership was commenced. The receivership was converted into a Chapter 10 proceeding and the equity court directed the receiver not to pay further coupons (representing interest) when due.¹⁴⁸ Considerable cash collateral accrued and the secured bondholders petitioned the court administering the Chapter 10 case to issue a fifty percent dividend to the bondholders out of accumulated cash.¹⁴⁹ The bondholders demanded that these payments first go to pay the default coupons and interest dating from the time the coupons became due—i.e., interest on interest.¹⁵⁰ Interest on interest was expressly required by the contract in

141. *Id.* at 464.

142. *Id.*

143. The reference to “value” of payments under the plan invokes a discount rate that must be used to see if cash distributions under the plan equate with the appraised value of the collateral. This discount rate has come to be called “cram down interest.” *Till v. SCS Credit Corp.*, 541 U.S. 465, 473 (2004).

144. *Id.* at 476 (“[T]he cram down provision mandates an objective rather than a subjective inquiry. That is, although § 1325(a)(5)(B) entitles the creditor to property whose present value objectively equals or exceeds the value of the collateral, it does not require that the terms of the cram down loan match the terms to which the debtor and creditor agreed prebankruptcy . . .”).

145. *Id.* at 474.

146. 329 U.S. 156, 159 (1946).

147. 489 U.S. 235, 248 (1989).

148. *Vanston*, 329 U.S. at 166 (“In fact, both [the debtor] and the receiver were ordered by the court not to pay the coupons on the dates they were, on their face, supposed to have been paid.”).

149. *Green v. Vauston Bondholders Protective Comm. (In re Am. Fuel & Power Co.)*, 151 F.2d 470, 473 (6th Cir. 1945). A similar motion was filed in *Urban Communicators PCS Ltd. P’ship v. Gabriel Capital L.P.*, 394 B.R. 325, 331–32 (S.D.N.Y. 2008).

150. *Vanston*, 329 U.S. at 159.

case of default.¹⁵¹ Translated into the language of the modern Bankruptcy Code, the bondholders sought the release of cash collateral not necessary to the conduct of the reorganizing business. They also sought interest on interest as part of what today would be called a section 506(b) entitlement. In short, the *Vanston* opinion precisely concerns the proper interest rate collectible by an oversecured creditor.

The district court ruled that the distribution should extinguish coupon interest and interest on coupon interest before it extinguished the claim for principal.¹⁵² Interest on interest was expressly required by the trust indenture.¹⁵³

The Sixth Circuit ruled that interest on interest was contrary to New York law, which it judged applicable to the question.¹⁵⁴ It therefore reversed that part of the district court's ruling with regard to interest on interest.¹⁵⁵ The Supreme Court, however, went further. It opined that a *federal* rule prevented interest on interest.¹⁵⁶

First, the Court observed, choice of law as to loan agreements in bankruptcy cases is too treacherous, as a loan agreement might engender contacts with many states, between which it would be difficult to choose.¹⁵⁷ Second, the *Vanston* Court located an oversecured creditor's right to pendency interest in "a balance of equities between creditor and creditor or between creditors and the debtor."¹⁵⁸ This balance implied that secured creditors might get pendency interest when "the security was worth more than the sum of principal and interest due."¹⁵⁹ But interest on interest (even though the contract required it) was beyond the pale and forts of reason. Any interest on interest accruing before the equity receivership could be claimed in the bankruptcy,¹⁶⁰ but the receivership (and later the reorganization proceeding) changed everything.

In fact, both [the debtor] and the receiver were ordered by the court not to pay the coupons on the dates they were, on their face, supposed to have been paid. The contingency which might have created a present obligation to pay interest on interest—*i.e.*, a free decision by the debtor that it would not or could no pay simple interest promptly—was prohibited from occurring by order of the court. That order issued for a good cause, we may assume: to pre-

151. *In re Am. Fuel & Power Co.*, 151 F.2d at 475.

152. *Vanston*, 329 U.S. at 160.

153. *Id.* at 159.

154. *Id.* at 160. New York has since then reversed itself and approved of interest on interest. *See* N.Y. GEN. OBLIG. LAW § 5-527 (McKinney 2014).

155. *Vanston*, 329 U.S. at 160.

156. *Id.* at 162–63.

157. *Id.* at 161–62 ("In determining which contact is the most significant in a particular transaction, courts can seldom find a complete solution in the mechanical formulae of the conflicts of law. Determination requires the exercise of an informed judgment in the balancing of all the interests of the states with the most significant contacts in order to best accommodate the equities among the parties to the policies of those states.")

158. *Id.* at 165.

159. *Id.* at 164.

160. *Id.* at 166.

serve and protect the debtor's estate pending a ratable distribution among all the creditors according to their interests as of the date the receivership began. The extra interest covenant may be deemed *added compensation for the creditor or, what is more likely, something like a penalty to induce prompt payment of simple interest*. In either event, first mortgage bondholders would have been enriched and subordinate creditors would have suffered a corresponding loss, because of a failure to pay when payment had been prohibited by a court order entered for the joint benefit of debtor, creditors, and the public. Such a result is not consistent with equitable principles. For legal suspension of an obligation to pay is an adequate reason why no added compensation or penalty should be enforced for failure to pay.¹⁶¹

In short, the *Vanston* case was all about whether what we now call section 506(b) (but was then a common law equity rule) includes a secured creditor's entitlement to postdefault penalty interest. The Supreme Court firmly answered no.¹⁶² It cannot be denied that there is a conflict between *Vanston* and *Rake*.¹⁶³ *Vanston* proclaims interest on interest (when called for by the contract) to be a penalty, whereas *Rake* proclaims interest on interest (when not called for by the contract) to be compensatory. Still, the cases can be reconciled in this respect: section 506(b) commands a compensatory rate of interest (including interest on unpaid interest), but it prohibits penalty rates that are supracompensatory.

If the *SW* court in the First Circuit authorizes the choice of a contractual penalty rate under section 506(b), the Ninth Circuit, in *General Electric Capital Corp. v. Future Media Products, Inc.*¹⁶⁴ takes the stronger view that a penalty contract rate is mandatory. The *Future Media* case involved facts analogous to those of *Vanston*, but the Ninth Circuit, ignoring *Vanston*, ruled that state law (not federal bankruptcy law) should govern whether the default rate of interest was due and owing.¹⁶⁵ This is precisely opposed to the direct holding in *Vanston*.¹⁶⁶ In so ruling (and remanding for further findings on the state of New York law), the Ninth Circuit relied on yet another Supreme Court opinion, *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*¹⁶⁷ *Travelers* involved an unsecured creditor's right to recover attorneys' fees for engaging in bankruptcy litigation.¹⁶⁸ *Travelers* was a cascade of error and mis-

161. *Id.* at 165–66 (emphasis added).

162. *Id.* at 165–67.

163. 508 U.S. 464 (1993). See David Gray Carlson, *Rake's Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization*, 13 BANKR. DEV. J. 273, 329–30 (1997); Dean Pawlowic, *Entitlement to Interest Under the Bankruptcy Code*, 12 BANKR. DEV. J. 149, 161 (1995).

164. 536 F.3d 969, 974 (9th Cir. 2008).

165. *Id.*

166. *Vanston*, 329 U.S. at 162.

167. *Future Media*, 536 F.3d at 973 (citing *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 444 (2007)).

168. See Mark S. Scarberry, *Interpreting Bankruptcy Code Sections 502 and 506: Post-Petition Attorneys' Fees in a Post-Travelers World*, 15 AM. BANKR. INST. L. REV. 611, 612 (2007).

understanding. The Ninth Circuit, following California law, had denied attorneys' fees to an unsecured creditor,¹⁶⁹ but it did so cryptically, citing *In re Fobian*,¹⁷⁰ a case that did not bother to cite the relevant California statute. *Fobian*, however, cited some federal cases based on California or Oregon law that held attorneys' fees relating to litigation over reorganization plans did not constitute fees relating to an action for breach of contract.¹⁷¹ In short, *Fobian* was founded on state law, which disallowed attorneys' fees for bankruptcy litigation unrelated to enforcing the contract.¹⁷² The Supreme Court, however, took *Fobian* to be a judicially created amendment to section 502(b).¹⁷³ The Court reversed on the theory that lower federal courts are not allowed to amend the Bankruptcy Code.¹⁷⁴ The entire exercise was based on a mistake concerning the origin of the so-called *Fobian* rule.

Compounding the error, the *Future Media* court read *Travelers* as mandating default rates of interest under Bankruptcy Code section 506(b):

Our analysis starts from a general premise recently articulated by the Supreme Court: “[c]reditors’ entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor’s obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.” We read *Travelers* to mean the default rate should be enforced, subject only to the substantive law governing the loan agreement, unless a provision of the Bankruptcy Code provides otherwise.¹⁷⁵

169. The attorneys' fees sought related to a creditor's opposition to a plan of reorganization, not to an "action on a contract." Accordingly, the fees could not be collected under CAL. CIV. CODE § 1717(a) (West 2014) ("In any action on a contract, where the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party, then the party who is determined to be the party prevailing on the contract, whether he or she is the party specified in the contract or not, shall be entitled to reasonable attorney's fees in addition to other costs.").

170. *Travelers*, 549 U.S. at 443–44 (citing *In re Elmer Fobian v. W. Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991)).

171. *In re Fobian*, 951 F.2d at 1153 (citing *Collingwood Grain, Inc. v. Coast Trading Co., Inc. (In re Coast Trading Co., Inc.)*, 744 F.2d 686 (9th Cir. 1984) (litigating over the reorganization plan not permitted under state law since Oregon statute limited attorneys' fees to services relating to contract enforcement); *Johnson v. Righetti (In re Johnson)*, 756 F.2d 738 (9th Cir. 1985) (seeking debtor attorneys' fees from creditor because the creditor's motion to lift the automatic stay was denied, thus bankruptcy litigation was not covered by Cal. Civil Code § 1717); *Grove v. Fulwiler (In re Fulwiler)*, 624 F.2d 908 (9th Cir. 1980) (litigating over bankruptcy discharge not related to an action on the contract)). For a good analysis of *Fobian's* basis in state law, see Jennifer M. Taylor & Christopher J. Mertens, *Travelers and the Implications on the Allowability of Unsecured Creditors' Claims for Post-Petition Attorneys' Fees Against the Bankruptcy Estate*, 81 AM. BANKR. L.J. 123, 128 (2007). Oddly, these authors reason that the cases on which *Fobian* relied found no basis for allowing attorneys' fees under state law and therefore disallowed them under a federal rule. In fact, the authors are half-right. The courts found the attorneys' fees to be contrary to state law and therefore followed the dictates of section 502(b) to the letter.

172. *Fobian*, 951 F.2d at 1153.

173. See *Travelers*, 549 U.S. at 444.

174. *Id.* at 453.

175. *Gen. Elec. Capital Corp. v. Future Media Prods. Inc.*, 536 F.3d at 973 (quoting *Travelers*, 549 U.S. at 450 (citing *Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 20 (2000) (dealing with state law on burden of proof governed in a claim for state taxes))).

Although *Travelers* is based on the Supreme Court's misunderstanding of the *Fobian* case, it is, after all, an interpretation of section 502(b) allowability of claims founded on nonbankruptcy law. Higher postdefault interest, in contrast, entails the meaning of section 506(b), which *requires* a federally made rule, since (per the Supreme Court's interpretation) section 506(b) disentitles an oversecured creditor to the contract rate of interest.¹⁷⁶ A fair reading of the Supreme Court opinions on interest rates (as opposed to allowability criteria for unsecured claims), leads to the opposite result from the one reached in *Future Media*: selection of the default rate is never acceptable in section 506(b), unless it is a proxy for the market rate of interest.

In ruling otherwise, the *SW* and *Future Media* courts effectively ignore no less than four Supreme Court opinions, while *Future Media* relies on a Supreme Court opinion that is irrelevant to the issue of postdefault interest under section 506(b). In contrast to these decisions, section 506(b) and the cram down provisions require a market rate, for which the contract rate is at best a proxy. If so, choice of the default rate seems most unjustified, as it is by definition a penalty rate, not a market rate.

To summarize, not all postdefault interest enhancements can be struck down as *ipso facto* clauses. But since section 506(b) can and should be read as requiring a market interest rate, the chance of a secured creditor depleting the bankruptcy estate with such a high postdefault interest rate is much reduced, provided the compensatory nature of section 506(b) is recognized.

B. Reinstatements

A proper reading of section 506(b) limits the effect of a higher postdefault interest rate for monetary defaults. A second reason that postdefault interest rates for monetary defaults minimally threaten the bankruptcy estate with depletion is that, properly, they may be avoided if the loan agreement is "reinstated." Courts have recently disagreed, however.¹⁷⁷

Each reorganization chapter encourages reinstatement of contractually required installments going forward.¹⁷⁸ The price of reinstatement, however, is cure of past defaults. Thus, reinstatement is forward looking, but cure of past defaults is backward looking.

176. Three authors have declared that it is open for lower courts to declare the postpetition attorneys' fees of *Travelers* to be disallowed, since, under section 506(b), only oversecured creditors are entitled to such fees. See Scarberry, *supra* note 168, at 636-56; Taylor & Mertens, *supra* note 171, at 139-60. If so, the Supreme Court opinion in *Travelers* is of singular unimportance.

177. See *In re Sagamore Partners, Ltd.*, 512 B.R. 296, 312 (S.D. Fla. 2014) (striking down postdefault rate as violative of state law); *In re Moody Nat'l SHS Houston H, LLC*, 426 B.R. 667, 672 (Bankr. S.D. Tex. 2010) (stating the plain meaning of section 1123(d) is that higher postdefault interest must be paid as part of the cure); *In re 139-141 Owners Corp.*, 306 B.R. 763, 770-71 (Bankr. S.D.N.Y. 2004), *aff'd in part, vacated in part, remanded*, 313 B.R. 364 (S.D.N.Y. 2004).

178. 11 U.S.C. §§ 1123(a)(5)(G), 1222(b)(3), 1222(b)(5), 1322(b)(3), 1322(b)(5) (2012).

In Chapter 11 cases, reinstatement affects creditor voting. In Chapter 11, the creditors vote on the mode of distribution.¹⁷⁹ This makes Chapter 11 different from Chapter 7 of the Bankruptcy Code. General creditors in Chapter 7 elect the trustee,¹⁸⁰ but they may not vote on distribution, which is dogmatically fixed by Bankruptcy Code section 726.¹⁸¹ In Chapter 11, however, creditors may vote on the distributional system promulgated by the plan.¹⁸²

Voting in Chapter 11 is by class.¹⁸³ There is good reason for this. Prior to the enactment of Bankruptcy Act section 77B¹⁸⁴ and the reorganization chapters that soon followed,¹⁸⁵ businesses were reorganized by means of equity receiverships under the pre-*Erie* federal common law.¹⁸⁶ The receiver could not force a creditor to compromise her claim. A creditor could hold out against a consensual plan in order to obtain a greater recovery.¹⁸⁷ Accordingly, while the principal creditors worked and sacrificed to save the going concern of a firm, the lesser creditors soon learned the profit in protesting too much; such creditors had to be cashed out in full, so that the larger creditors—the ones who really stood to lose if the company were not reorganized—could proceed by compromise to reorganize the company.

The reorganization legislation therefore introduced class voting, so that marginal creditors could not hold up the entire proceeding in order to obtain preferences.¹⁸⁸ The Bankruptcy Code continues these rules. It requires that two-thirds of claims (by amount) in the class vote yes, and, in addition, that a flat majority (by head count) also vote yes.¹⁸⁹ If the class votes in favor of the plan, dissenting creditors within the class are forced to go along with the majority, at least for voting purposes.¹⁹⁰ If the

179. *Id.* § 1126(a).

180. David Gray Carlson, *The Classification Veto in Single-Asset Cases Under Bankruptcy Code Section 1129(a)(10)*, 44 S.C.L. REV. 565, 572 n.22 (1993).

181. *See* United States v. Noland, 517 U.S. 535, 543 (1996) (holding that equitable subordination doctrine may not be used to legislate new Chapter 7 priorities).

182. Carlson, *supra* note 180, at 571.

183. *Id.* at 572.

184. Act of June 7, 1934, ch. 424, Pub. L. No. 296, 48 Stat. 911, 912–22 (1934).

185. Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed 1978).

186. Carlson, *supra* note 180, at 572.

187. *Werner, Harris & Buck v. Equitable Trust Co.*, 35 F.2d 513, 514 (10th Cir. 1929) (“Each bondholder has the absolute right to determine for himself, in case of default, whether he shall take his loss and quit, or continue to gamble”); E. Merritt Dodd, Jr., *Reorganization Through Bankruptcy: A Remedy for What?*, 48 HARV. L. REV. 1100, 1100–03 (1935). The Bankruptcy Act of 1867 and the little-used creditor compositions of Section 12 of the Bankruptcy Act of 1898 also contained class voting as well. *See* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 87 (1990).

188. *See In re Herweg*, 119 F.2d 941, 943 (7th Cir. 1941) (emphasizing that old section 77B was founded on the principle of stifling dissent).

189. 11 U.S.C. § 1126(c) (2012).

190. Thus, in *In re 11,111, Inc.*, 117 B.R. 471 (Bankr. D. Minn. 1990), two minor creditors, classified together with huge yes-voting creditors, demanded separate classification so that they could preserve their cram down rights. On gerrymandering schemes in Chapter 11 cases, see *W. Real Estate Equities, L.L.C. v. Vill. at Camp Bowie I, L.P.* (*In re Vill. at Camp Bowie I, L.P.*), 710 F.3d 239 (5th Cir. 2013); Carlson, *supra* note 180, at 566.

class votes no, then the plan may still be confirmed, but only if the debtor crams down the plan under section 1129(b).¹⁹¹

One must not overestimate the importance of voting in Chapter 11. Generally, even if creditors vote no, the plan can be confirmed nevertheless, provided the so-called “cram down” rules of section 1129(b) are met. This principle is established by the following phrase from section 1129(b): “if all of the applicable requirements of subsection (a) of this section *other than paragraph (8)* are met with respect to a plan, the court, on request for the proponent of the plan, shall confirm the plan notwithstanding the requirement of such paragraph”¹⁹²

Section 1129(a)(8) in turn requires:

With respect to each class of claims or interests—

(A) such class has accepted the plan; or

(B) such class is not impaired under the plan.¹⁹³

Thus, if an impaired class votes no, the plan may still be confirmed by means of cram down. A no vote, then, does nothing more than trigger the cram down protections,¹⁹⁴ with the proviso that if *all* classes vote no, confirmation of the plan becomes impossible.¹⁹⁵

Only impaired creditors may vote in Chapter 11. Unimpaired creditors are deemed to accept the plan.¹⁹⁶ As the legislative history put it, “[t]he holder of a claim or interest who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain.”¹⁹⁷

Section 1124 describes *all* claims in Chapter 11 as impaired, with two exceptions: (1) If the plan leaves the creditor’s rights unaltered, or (2) if the plan cures all past defaults and reinstates the security agree-

191. See § 1129(b); see generally *Olympia & York Fla. Equity Corp. v. Bank of N.Y. (In re Holywell Corp.)*, 913 F.2d 873, 879–80 (11th Cir. 1990) (describing the relation between Bankruptcy Code Sections 1129(a) and 1129(b)); *Teamsters Nat’l Freight Indus. Negotiating Comm. v. U.S. Truck Co., Inc. (In re U.S. Truck Co., Inc.)*, 800 F.2d 581, 583 (6th Cir. 1986) (“Confirmation under subsection (b) is commonly referred to as a ‘cram down’ because it permits a reorganization plan to go into effect over the objections of one or more impaired classes of creditors.”).

192. § 1129(b)(1) (emphasis added).

193. *Id.* § 1129(a)(8).

194. See *In re Polytherm Indus., Inc.*, 33 B.R. 823, 838 (W.D. Wis. 1983) (“The impairment determination can be viewed as a statutorily prescribed measurement for determining when the protections established in . . . § 1129(b) should be accorded a class of creditors.”).

195. § 1129(a)(10).

196. *Id.* § 1126(f). See *In re Moody Nat’l SHS Houston H, LLC*, 426 B.R. 667, 670–72 (Bankr. S.D. Tex. 2010). Conclusively so, since 1984. Prior to 1984, some courts thought that creditors who *actually* voted no would be entitled to cram down rights, like other no-voting creditors, thereby depriving the debtor of the benefits of disimpairment. Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 84 (1986).

197. S. REP. NO. 989, at 120, reprinted in 1978 U.S.C.A.N. 5787, 5906. This remark perhaps underestimates the nearly boundless power of complaint that resides in creditors. Creditors might complain that, but for bankruptcy, the debtor would have defaulted and creditors could have reinvested liquidation proceeds at a higher rate of interest. Yet Congress has clearly decided that this excess value in the loan agreement belongs to the general creditors—not to the specific creditor whose agreement is reinstated.

ment,¹⁹⁸ the claim is considered not impaired, and the creditor in question is deemed an automatic yes vote on the plan.¹⁹⁹

Impairment by a plan constitutes virtually any change in rights.²⁰⁰ Thus, a change in the maturity date,²⁰¹ or a substitution of debtors,²⁰² or collateral²⁰³ is impairment, even if the collateral is better in quality and quantity.²⁰⁴ Lump sum payment in lieu of installments,²⁰⁵ and, by some accounts, even an improvement in position is an impairment.²⁰⁶ On the oth-

198. Section 1124(2) provides:

Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan--

...

(2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default--

(A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title;

(B) reinstates the maturity of such claim or interest as such maturity existed before such default;

(C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;

(D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claims or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and

(E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

The preamble to section 1124 refers to section 1123(a)(4) as an exception. Section 1123(a)(4) requires that a plan provide equal intra-class treatment of creditors, unless the creditors vote otherwise. Its presence as an exception to disimpairment suggests that discriminatory intra-class treatment makes any claim impaired. § 1124(2).

199. *Id.* § 1126(f).

200. *Di Pierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 28 (2d Cir. 1982) (saying Congress “defined impairment in the broadest possible terms”).

201. *Ronit, Inc. v. Block Shim Dev. Co.—Irving (In re Block Shim Dev. Co.—Irving)*, 118 B.R. 450, 455 (N.D. Tex. 1990).

202. *Bustop Shelters of Louisville, Inc. v. Classic Homes, Inc.*, 914 F.2d 810, 814 (6th Cir. 1990); *In re Barrington Oaks Gen. P’ship*, 15 B.R. 952, 961 (Bankr. D. Utah 1981).

203. *In re Gagel & Gagel*, 30 B.R. 627, 629–30 (Bankr. S.D. Ohio 1983).

204. MARTIN BIENENSTOCK, BANKRUPTCY REORGANIZATION 596 (1987).

205. *In re Otero Mills, Inc.*, 31 B.R. 185, 186–87 (Bankr. D.N.M. 1983).

206. *In re Temple Zion*, 125 B.R. 910, 919 (Bankr. E.D. Pa. 1991). In *L & J Anaheim Assocs. v. Kawasaki Leasing Int’l, Inc. (In re L & J Anaheim Assocs.)*, 995 F.2d 940 (9th Cir. 1993), a secured party sponsored a Chapter 11 plan which consigned the unsecured deficit claim to a unique class. The secured party’s plan awarded its own unsecured deficit claim improved rights. The class was the only one voting yes on the plan. The court ruled that the class was impaired by virtue of its *improved* rights. As a result, the plan could be confirmed because, by this dubious means, the secured party had met the requirements of section 1129(a)(10). Some courts disagree that an improvement in position is impairment. In *Bustop Shelters of Louisville, Inc. v. Classic Homes, Inc.*, 914 F.2d 810 (6th Cir. 1990), a plan assumed a security agreement and provided a secured party obtained a surety in addition to the debtor’s continued liability. The additional surety—an improvement in position—was held not to be an impairment, even though the debtor’s equity in the collateral was transferred to the surety. Although these changes “altered” the creditor’s prepetition rights, the court ruled that the secured party was not impaired, and its vote could not count in aid of the plan. *Id.* at 814–15. *Bustop* might be reconciled with *Anaheim Associates* by observing that the contractual relations between the secured party and original debtor were left untouched; the creation of *new* relations between the secured party and the surety did not therefore alter the original debtor-creditor relationship.

For another case that denies improvement in position is impairment, see *In re Boston Post Rd. Ltd. P’ship*, 145 B.R. 745, 747 (Bankr. D. Conn. 1992), *aff’d*, 154 B.R. 617 (D. Conn. 1993), *aff’d*, 21 F.3d 477 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995).

er hand, courts apparently may overlook minor “technical” impairments.²⁰⁷

Impairment had been defined under old Chapter 10 as a “material and adverse” effect on a claim.²⁰⁸ Such a standard entailed vexing valuation standards. Obviously, the modern Bankruptcy Code has lightened this standard.²⁰⁹ It has been suggested that the standard should not depend on any quantitative effects on the value of a creditor’s claim, but merely on qualitative change of any sort.²¹⁰ Impairment should be found easily, and contested Chapter 11 plans should rise and fall on cram down criteria.

In Chapter 12 and 13 cases, there is no class voting, and so the purpose of reinstatement is rather different.²¹¹ Chapter 12, pertaining to the reorganization of farmers, is the lesser known country cousin of Chapter 13. Passed during the farm crisis in 1986,²¹² Chapter 12 is simply a marked-up version of Chapter 13, with changes appropriate to the context of distressed farmers. There are nevertheless some important differences. In Chapter 12, any secured claim may be modified, including a home mortgage.²¹³ Thus, in Chapter 12, a farmer need not reinstate a mortgage agreement in order to save the family home. Cram down of the home mortgage is always possible. In contrast, both Chapter 11 and Chapter 13 prevent modification of loan agreements in which the debtor’s residence is the only collateral.²¹⁴ A Chapter 12 plan, however, may only last five years. Reinstatement then becomes a way of extending the effects of the plan beyond the five year maximum. In Chapter 13 cases, reinstatement is the only way to save the family home from foreclosure.²¹⁵

207. *In re Orlando Tennis World Dev. Co.*, 34 B.R. 558, 562 (Bankr. M.D. Tenn. 1983) (change of management violated covenant but was overlooked on the grounds it was “technical”).

208. *In re Witt*, 60 B.R. 556, 561 (Bankr. N.D. Iowa 1986).

209. *Id.*

210. *Anaheim Assocs.*, 995 F.2d at 942 (citing *In re Barrington Oaks Gen. P’ship*, 15 B.R. 952, 962 (Bankr. D. Utah 1981)).

211. *See, e.g., Di Pierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 25 (2d Cir. 1982) (providing an example of reinstatement saving the family home).

212. For a description of Chapter 12, see Janet A. Flaccus, *A Comparison of Farm Bankruptcies in Chapter 11 and the New Chapter 12*, 11 U. ARK. LITTLE ROCK L. REV. 49, 51 (1988). For a history tracing Chapter 12 back to the Frazier-Lemke Act in the Depression, see James J. White, *Taking From Farm Lenders and Farm Debtors: Chapter 12 of the Bankruptcy Code*, 13 J. CORP. L. 1, 4 n.6 (1987); Barry G. Grandon, Note, *The Family Farm Bankruptcy Act of 1986 and the Elimination of Lost Opportunity Costs Under Chapter 12*, 14 OHIO N.U. L. REV. 103, 104 (1987). Professor White tweaks the nose of the Republican Party for generating the very legislation that it denounced as bolshevist in the 1930’s. Chapter 12 originally had a “sunset” provision that cancels the chapter on October 1, 1993. Pub. L. 99-554, Tit. III, § 302(f), 100 Stat. 3124 (Oct. 27, 1986). But the popularity of Chapter 12 was sufficient to guarantee the extension of Chapter 12 in 1993 for another five years. Pub. L. 103-65, 107 Stat. 311 (Aug. 6, 1993). Eventually Chapter 12 was made permanent. Pub. L. 109-8 § 1001(a) (2005).

213. 11 U.S.C. § 1222(b)(2) (2012).

214. *Id.* §§ 1123(b)(5), 1322(b)(2). In 1994, Congress added an exception to this principle with regard to mortgages whose terms do not extend beyond the length of a Chapter 13 plan. *Id.* § 1322(c)(2). No similar provision was adopted in Chapter 11. *See id.* § 1123(b)(5).

215. *See, e.g., Di Pierro v. Taddeo (In re Taddeo)*, 685 F.2d 24, 25 (2d Cir. 1982) (providing an example of reinstatement saving the family home).

In addition, reinstatement may, as in Chapter 12, extend beyond the five year maximum for the duration of a plan.²¹⁶

The price of reinstatement is cure of past defaults. Prior to 1994, the Bankruptcy Code never got around to defining what “cure” might mean.²¹⁷ Accordingly, in *Rake v. Wade*,²¹⁸ the Supreme Court inartfully filled in the gap. In *Rake*, a Chapter 13 debtor wished to cure defaults in a mortgage agreement, as is authorized under section 1322(b)(5), so that the mortgage agreement might be reinstated going forward.²¹⁹ Such reinstatement overrides the rule in section 1322(b)(2) against modifying home mortgages and, in addition, permits the reinstated debt to be paid over time beyond the life of a Chapter 13 plan, which is otherwise limited to a maximum of five years.²²⁰ The debtor proposed to cure defaults of principal and interest past due by paying those amounts within “a reasonable time,” as section 1322(b)(5) authorizes.²²¹ The debtor proposed to pay no interest on these past defaults, covering the period between the default and the calculation of the price of cure.²²² Indeed, in Chapter 13, administrative expenses and taxes might be paid over time without an interest component to compensate for delay,²²³ so it was reasonable for the debtor to interpret section 1322(b)(5) as not requiring interest compensation.

The *Rake* contract said nothing about the cure of past defaults.²²⁴ The creditor, however, was oversecured, and therefore insisted that section 506(b) entitled the creditor to pendency interest on the cure claim, because the cure claim was part of the secured claim.²²⁵ This amounted to interest on interest, something that state law (sometimes)²²⁶ and the Su-

216. § 1322(d)(1).

217. *Great W. Bank & Trust v. Entz-White Lumber & Supply, Inc.* (*In re Entz-White Lumber & Supply, Inc.*), 850 F.2d 1338, 1340 (9th Cir. 1988); *In re Clark*, 738 F.2d 869, 871 (7th Cir. 1984).

218. 508 U.S. 464 (1993).

219. *Id.* at 466.

220. § 1322(d).

221. *Rake*, 508 U.S. at 466; § 1322(b)(5).

222. *Rake*, 508 U.S. at 466. Several appellate opinions required interest on these defaults only if the contract called for it. *E.g.*, *Landmark Fin. Servs. v. Hall*, 918 F.2d 1150, 1155 (4th Cir. 1990).

223. § 1322(a)(2) (stating that a Chapter 13 plan “shall provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507”). This must be compared to the cram down provision in section 1325(a)(5)(B)(ii), which requires that a secured creditor receive “the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim.” § 1325(a)(5)(B)(ii). The reference to value in the cram down provision invokes a discount rate. The absence of such a term in section 1322(a)(2) negates the necessity for a discount rate.

224. *Rake*, 508 U.S. at 467.

225. *Id.* at 470.

226. *Shapiro v. Bailen*, 199 N.E. 315, 316 (1936); *In re Manville Forest Prods. Corp.*, 43 B.R. 293, 303 (Bankr. S.D.N.Y. 1984) (collecting examples), *rev'd on other grounds*, 60 B.R. 403 (S.D.N.Y. 1986); Craig H. Averch et al., *The Right of Oversecured Creditors to Default Rates of Interest from a Debtor in Bankruptcy*, 47 BUS. LAW. 961, 964 & n.23 (1992). Other states allow interest on interest if it is in the contract. CAL. CIV. CODE § 1916-2 (West 1985); N.Y. GEN. OBLIG. LAW § 5-527 (McKinney 1989); *Gincastro v. Fairlawn Credit Union* (*In re Gincastro*), 48 B.R. 662, 665 (Bankr. D.R.I. 1985) (disallowing interest on interest because not in the contract).

preme Court itself (in the name of bankruptcy equity)²²⁷ has disallowed. Even though the contract did not call for interest on interest, the Supreme Court upheld the idea that section 506(b) requires it as part of the cure.²²⁸ In so doing, it relied on *Ron Pair's* principle that section 506(b) interest entitlements are unrelated to the contract.²²⁹ Accordingly, the absence of a contractual provision did not excuse the debtor from paying interest on arrears (including interest on interest past due) as part of the price of cure.²³⁰

The reasoning in *Rake* is certainly open to criticism. The spirit of cure is compensatory—to restore the secured creditor to the position it would have enjoyed if there had been no default. In determining what cure is—what is due and owing—a court properly looks only at the loan contract, not the collateral (interest, however, being noncontractual and compensatory, per *Ron Pair*). Yet the requirement that interest be paid only when the secured creditor is oversecured requires a reference to the collateral, which can have no analytical role to play in compensating for losses from breach of the loan agreement.

In 1994, Congress chose to reverse *Rake*, insofar as *Rake* found section 506(b) at all relevant to the cure price. In particular, Congress added sections 1123(d), 1222(d), and 1322(e), requiring the cure price to be “determined in accordance with the underlying agreement and applicable nonbankruptcy law.”²³¹ Section 1123(d) provides: “[n]otwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7), and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.”²³² This provision and its Chapter 12 and 13 versions are to apply “notwithstanding” section 506(b).²³³ Hence, it is no longer the case that an interest component of the cure price turns on the presence of a valuable debtor equity. Rather,

227. *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 165 (1946). *Vanston* was followed to disallow interest on interest under section 506(b) in *In re Laymon*, 117 B.R. 856, 864 (Bankr. W.D. Tex. 1990), *rev'd on other grounds*, 958 F.2d 72 (5th Cir. 1990), *cert. denied sub nom.*, *Crozier v. Bradford*, 506 U.S. 917 (1992). On appeal, the Fifth Circuit seemed to agree that *Vanston* was also relevant to curtail higher postdefault interest rates.

Three authors, who would like to preserve higher postdefault interest rates, argue that *Vanston* turns on the fact that interest on interest was triggered after the district court prohibited the debtor from making current interest payments. By then, what we now call the automatic stay would prevent the creditors from invoking a default clause in the contract. If interest on interest, they argue, had begun accrual prior to the bankruptcy petition, then it can continue to accrue right on through the petition. See Averch et al., *supra* note 226, at 963–64.

This analysis does not entirely follow. A contract requiring higher postdefault interest may not require the debtor to *declare* a default. It may happen automatically, in which case the automatic stay does not inhibit postdefault interest, or interest on interest. In addition, in modern times, *Ron Pair* seems to indicate that the contract is irrelevant in any case to set the proper interest rate. Therefore, disabling *Vanston* does not further the cause of upholding contractual postdefault interest rates.

228. *Rake v. Wade*, 508 U.S. 464, 471 (1993).

229. *Id.*

230. *Id.* at 475.

231. 11 U.S.C. §§ 1123(d), 1222(d), 1322(e) (2012).

232. *Id.* § 1123(d).

233. *Id.* §§ 1123(d), 1222(d), 1326(d).

whenever the contract requires interest for the repayment of overdue installments—interest on interest—the cure price must include this component. Section 506(b) no longer applies to affect the cure price.

According to the 1994 legislative history, section 1123(f) would have the effect of overruling the decision of the Supreme Court in *Rake v. Wade* Notwithstanding State law, this case has had the effect of providing a windfall to secured creditors at the expense of unsecured creditors by forcing debtors to pay the bulk of their income to satisfy the secured creditors' claims. This had the effect of giving secured creditors interest on interest payments, and interest on the late charges and other fees, even where applicable laws prohibit[] such interest and even when it was something that was not contemplated by either party in the original transaction. . . . It is the Committee's intention that a cure pursuant to a plan should operate to put the debtor in the same position as if the default had never occurred.²³⁴

If we take this paragraph from the legislative history seriously, it should be apparent that the meaning of section 1123(d) is to reinstitute a compensatory theory of cure—one that has reference to the contract, not the collateral and not to whether the creditor was over- or undersecured. It does not permit the contract to define cure in a way to provide for penalties and windfalls. Preventing windfalls is in fact what section 1123(d) is all about. Therefore, in a reinstatement case, a court should consider the contract only for the purpose of figuring out a proper compensation for past defaults. It should not consider self-serving pronouncements in the contract as to what a cure would be.

This is doubly true in the case where a postdefault interest is triggered by an *ipso facto* event. These clauses have already been eliminated from the contract by the workings of section 541(c)(1), which brings collateral into the bankruptcy estate free and clear of any such clauses. In support of the view that the new definition of cure price does not authorize higher default interest rates, whether arising from an *ipso facto* clause or from a monetary default, it may be noted that section 1124(2)(A) requires a reinstating debtor to cure “any such default that occurred before or after the commencement of the case under this title, *other* than a default of a kind specified in section 362(b)(2) of this title or of a kind that section 362(b)(2) expressly does not require to be cured.”²³⁵

Among the things that section 365(b)(2) excuses from cure is “(D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.”²³⁶ While this provision, also added in the 1994 amendments, refers to executory contracts, its incorporation into section 1124(b) (involving nonexecutory

234. H.R. REP. NO. 103-835, at 55 (1994) (citation omitted).

235. § 1124(2)(A) (emphasis added).

236. § 365(b)(2).

contracts) requires that the “penalty rate” be read to mean postdefault interest rates, whether triggered by an *ipso facto* or a monetary default.²³⁷

Notice that the 1994 amendments added both section 1123(d) and section 365(b)(2)(D) in the same legislative enactment. The first provision requires compensation “in accordance with the underlying agreement.”²³⁸ The second excuses payment of “penalty rates” as part of the cure of leases.²³⁹ Preexisting the 1994 amendments was section 1124(2)(A), which excludes section 365(d) items from the calculation of cure.²⁴⁰ Putting all of these points together, it is impossible to avoid the conclusion that Congress intended the cure to be free and clear of postdefault interest hikes. Indeed, the legislative history expressly equates postdefault interest rates as penalty rates that need not be paid: “[f]inally, section 365(b) is clarified to provide that when sought be a debtor, a lease can be cured at a *nondefault rate* (i.e., it would not need to pay penalty rates).”²⁴¹

There is, however, an ambiguity in section 365(b)(2)(D). Once again, that provision reads: “the satisfaction of [A] any penalty rate or [B] penalty²⁴² provision [C] relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.”²⁴³

The issue is whether this provision excuses all or just some penalty rates. If clause [C] modifies clause [B] only, then the prohibition of a penalty rate is absolute in a reinstatement.²⁴⁴ If, on the other hand, clause [C] modifies both clauses [A] and [B], then only *some* penalty rates are prohibited—rates triggered by nonmonetary defaults.²⁴⁵

Distinguishing between legal and illegal penalty rates does not make much sense. Whether the higher rate stems from missing a payment or from some nonmonetary cause, these rates come out of the

237. For a contrary opinion, see *In re Moody Nat'l SHS Hous. H, LLC*, 426 B.R. 667, 674 (Bankr. S.D. Tex. 2010), where the court concludes that, since section 365(b)(2) refers to executory contracts, it can have no relevance to cure and reinstatement of a loan agreement. Yet the original Bankruptcy Code refers to section 365(b)(2) as applying to “executed” contracts. Obviously, Congress in 1978 was attempting to impose the *ipso facto* policy to executed contracts, albeit in a less-than-elegant way. What else could section 1124(2)(A) mean? That Congress in 1994 simultaneously directed that cure refer to the contract but that penalty rates should not apply (in leases and in reinstated loan agreements) shows a clear intent to make reinstatement (coupled with compensatory cure) a means to avoid postdefault penalty rates.

238. H.R. REP. NO. 103-835, at 20 (1994).

239. *Id.* at 50.

240. *Id.* at 114.

241. *Id.* at 50 (emphasis added).

242. This second invocation of the word “penalty” was added by Congress in 2005. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 328, 119 Stat. 23 (2005) (amending “penalty rate or provision” to “penalty rate or penalty provision”).

243. 11 U.S.C. § 365(b)(2)(D) (2012). I have added the brackets to identify the ambiguous modifier [C].

244. For sources so interpreting section 365(b)(2)(D), see *In re Zamani*, 390 B.R. 680, 686 (Bankr. N.D. Cal. 2008); *In re Phx. Bus. Park Ltd. P'ship*, 257 B.R. 517, 521 (Bankr. D. Ariz. 2001); Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR. L.J. 551, 558 (1995).

245. See *In re Sagamore Partners, Ltd.*, 512 B.R. 296, 312 (S.D. Fla. 2014); *In re 1 Ashbury Court Partners, L.L.C.*, No. 11-10131, 2011 WL 4712010 at *4 (Bankr. D. Kan. Oct. 5, 2011).

pockets of the unsecured creditors. Furthermore, given that these rates are supra-compensatory, it makes little sense to maintain that clause [C] above modifies clause [A].

Nevertheless, the court in *In re Sagamore Partners, Ltd.*,²⁴⁶ noted that in 2005 Congress added the word “penalty” to clause [B].²⁴⁷ Supposedly, this was motivated by a desire that clause [C] modify both clauses [A] and [B]. This may be doubted. It could also plausibly be seen that Congress wanted nonpenalty provisions in leases (relating to nonmonetary defaults) to be honored. Indeed, a fair guess is that the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) intended to overrule *Worthington v. GMC (In re Claremont Acquisition Corp)*.²⁴⁸ In that case, the debtor wanted to assume and assign an automobile franchise to sell General Motors cars.²⁴⁹ The debtor, however, had breached the franchise agreement for failing to operate the business for seven consecutive days.²⁵⁰ General Motors claimed that any provision that was not a “penalty” provision had to be cured, and, since that was not done with regard to the seven-day provision, the contract could not be cured.²⁵¹ The court, however, ruled that the word “penalty” only appeared in clause [A] and not in clause [B].²⁵² Therefore, the debtor was excused from curing a “provision relating to a default arising from any failure of the Debtor to perform nonmonetary obligations under an executory contract”²⁵³ By adding the word “penalty” to clause [B], BAPCPA effectively reverses *Claremont Acquisition*. If this was the principal motive, it is quite open to find that clause [C] modifies only clause [B] and *not* clause [A].

Given that the distinction between penalty rates from monetary defaults and penalty rates from nonmonetary defaults is not rational, the *Sagamore* court’s conclusion is certainly not required. And certainly not on the pretext that BAPCPA intended to impose this distinction between penalty rates.

As further evidence that section 1123(d) does not authorize *ipso facto* clause default penalties, it may be observed that, in 2005, BAPCPA, in one singular instance, encourages the enforcement of *ipso facto* clauses. That Congress did not extend this privilege beyond the one instance mentioned may be taken to show that, in all other cases, the federal policy against *ipso facto* clauses continues unabated. The BAPCPA provision in question involves *ipso facto* clauses in security agreements pertaining to automobiles.²⁵⁴ Some pre-BAPCPA cases had

246. 512 B.R. 296 (S.D. Fla. 2014).

247. *Id.* at 310 n.6.

248. 113 F.3d 1029 (9th Cir. 1997).

249. *Id.* at 1031.

250. *Id.* at 1033.

251. *Id.*

252. *Id.*

253. *Id.* This was how section 365(b)(2)(D) read before BAPCPA.

254. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 328, 119 Stat. 23 (2005).

indicated that, where a consumer debtor kept current on a car loan and where the car was abandoned by the trustee from the bankruptcy estate, so that the automatic stay no longer prohibited repossession of the collateral, a secured party could not invoke the *ipso facto* clause as a reason to repossess the automobile.²⁵⁵ This has been nicknamed the “ride-through”—where a consumer debtor need not reaffirm the security agreement or abandon the car but could, in effect, reinstate the car loan going forward (while enjoying a discharge for any unsecured deficit).²⁵⁶ New section 521(d) provides:

If the debtor fails timely to take the action specified in subsection (a)(6) of this section, or in paragraphs (1) and (2) of section 362(h), with respect to property which a . . . creditor holds a security interest not otherwise voidable . . . nothing in this title shall prevent or limit the operation of a provision in the underlying . . . agreement that has the effect of placing the debtor in default under such lease or agreement by reason of the occurrence, pendency or existence of a proceeding under this title or the insolvency of the debtor. Nothing in this subsection shall be deemed to justify limiting such a provision in any other circumstances.²⁵⁷

Note in particular that Congress says *specifically* in the last sentence that it knows how to overrule the policy against *ipso facto* clause in this circumstances but intends not to do so elsewhere. This serves as some evidence that Congress did not intend section 1123(f) to authorize penalties generated by either *ipso facto* or monetary defaults.

IV. SOLVENT DEBTORS

Under the Bankruptcy Act of 1898, at least prior to 1939, only insolvent debtors could file for bankruptcy.²⁵⁸ Today, solvent debtors can and do file bankruptcy petitions.²⁵⁹ Many cases exist where higher postdefault interest was required by the contract and the debtor was solvent after the bankruptcy.²⁶⁰

Solvent debtors who try to escape the contract terms that they freely entered into make for unattractive litigants. In *In re 139-141 Owners Corp.*,²⁶¹ the debtor was at all times highly solvent: “the debtor’s assets exceeded its liabilities by more than double”²⁶² During the

255. Home Owners Funding Corp. of Am. v. Belanger (*In re Belanger*), 962 F.2d 345, 347 (4th Cir. 1992); Lowry Fed. Credit Union v. West, 882 F.2d 1543, 1546 (10th Cir. 1989).

256. Jean Braucher, *Rash and Ride-Through Redux: The Terms for Holding on to Cars, Homes and Other Collateral under the 2005 Act*, 13 AM. BANKR. INST. L. REV. 457, 475 (2005).

257. 11 U.S.C. § 521(d) (2012).

258. Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not Be Article III Judges*, 72 AM. BANKR. L.J. 567, 631 n.346 (1998).

259. *Id.* at 631.

260. *E.g.*, Urban Communicators PCS Ltd. P’ship v. Gabriel Capital, L.P., 394 B.R. 325, 342 (Bankr. S.D.N.Y. 2008).

261. 306 B.R. 763 (Bankr. S.D.N.Y. 2004), *aff’d in part, vacated in part, remanded*, 313 B.R. 364 (S.D.N.Y. 2004).

262. *Id.* at 766.

term of the loan, the debtor's equity owner decided to divert rent from mortgage payments toward a "disastrous investment in a restaurant" and a clothing store.²⁶³ As a result, monetary defaults occurred.²⁶⁴ The debtor "filed for bankruptcy for the sole purpose of avoiding its obligation to pay interest at the default rate."²⁶⁵ The court ruled that the higher default interest had to be paid.²⁶⁶

It is hard to be sympathetic to such strategic bankrupts. But my dry task is not to judge the moral worth of the debtor, but rather is to read the Bankruptcy Code and to apply it by its terms, according to the guidance supplied by the Supreme Court. On the premises I have argued for, *139-141 Owners* was wrongly decided. The debtor, though solvent, should have been relieved of the obligation to pay higher postdefault interest.

Three reasons support this view. The Supreme Court on at least two (arguably four) occasions has held that, with regard to section 506(b), the contract does not govern the interest rate to which oversecured creditors are entitled. In addition, cure of a default in an "executed" contract can be accomplished without "the satisfaction of any penalty rate . . ."²⁶⁷ Third, if the default in question is purely an *ipso facto* event and not a monetary default, collateral enters estate free and clear of the *ipso facto* clause.²⁶⁸ All of these reasons apply whether the debtor is solvent or insolvent.

Modern courts rely on the pre-Code case *Ruskin v. Griffiths*²⁶⁹ for the proposition that the postdefault rate is allowable whenever the debtor is solvent.²⁷⁰ In *Ruskin*, the court read *Vanston* as turning on creditor-versus-creditor equities. But when the issue was between creditor-versus-debtor, the equities changed. The *Ruskin* court was able to quote *Vanston* as follows: "[b]ut where an estate was ample to pay all creditors and to pay interest even after the petition was filed, equitable considerations were invoked to permit payment of this additional interest to the secured creditor rather than to the debtor."²⁷¹

263. *Id.* at 767.

264. *Id.*

265. *Id.*

266. *Id.* at 772–73.

267. 11 U.S.C. § 365(b)(2)(D) (2012). This provision is applicable to "executed contracts" under 11 U.S.C. § 1124(2)(A).

268. See *supra* text accompanying notes 61–63.

269. 269 F.2d 827 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960).

270. The court in *In re Gen. Growth Props.*, 451 B.R. 323, 326 n.4 (Bankr. S.D.N.Y. 2011), cites *Citibank, N.A. v. Nyland (CF8) Ltd.*, 878 F.2d 620, 625 (2d Cir. 1989), for the proposition that *Ruskin* is still good law. But *Nyland* is not a bankruptcy case. Rather, it is a foreclosure action under state law, as to which neither *Vanston* nor *Ruskin* are in the slightest way relevant. *Ruskin* is cited in Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re Dow Corning Corp.*), 456 F.3d 668, 679 (6th Cir. 2006), but this case involves the rights of unsecured creditors to contract interest when a debtor is solvent. Properly, *In re SW Boston Hotel Venture, LLC*, 748 F.3d 393 (1st Cir. 2014), is the only recent Circuit Court opinion that still finds the *Ruskin* principle to be viable (though *Ruskin* is not cited).

271. 329 U.S. 156, 164 (1946).

It seems to me, however, that section 506(b), as interpreted by the Supreme Court, enforces prebankruptcy entitlements under “specified terms and conditions rather than a flight of redistributive fancy or a grant of free-wheeling discretion such as the medieval chancellors enjoyed”²⁷² *Ruskin* may have been soundly reasoned in its day, but section 506(b) now provides different rules, whereby interest merely compensates an oversecured creditor at the market rate of interest. *Ruskin* cannot serve as authority for higher postdefault interest rates, given section 506(b), as interpreted in *United States v. Ron Pair Enterprises, Inc.*²⁷³ and *Rake v. Wade*.²⁷⁴

Especially inappropriate are solvent cases where the only default is an *ipso facto* variety, of which *In re General Growth Properties*²⁷⁵ is an example. In this case the secured creditor was deemed entitled to higher interest solely because the debtor had filed a bankruptcy petition.²⁷⁶ But, as we have seen, encumbered property enters the bankruptcy estate free of *ipso facto* clause clauses in the security agreement, thanks to section 541(c)(1). Because the collateral is scoured of such clauses, there can be no justification for imposing a postdefault rate on *ipso facto* grounds.

V. CONCLUSION

In this Article, I have argued that higher postpetition interest rates are almost never justified. If triggered by *ipso facto* clauses, the higher interest must be disallowed because section 541(c)(1) scours from collateral any “modification” if a creditor’s right to collateral based on an *ipso facto* event.²⁷⁷ If triggered by a monetary default, higher postdefault interest is hardly ever justified. “Pendency” interest under section 506(b) is a noncontractual matter, according to at least two Supreme Court opinions.²⁷⁸ Rather, a market rate must be chosen. If the contract rate is chosen, it must be chosen solely because it is a reasonable proxy for the market rate of interest. This usually rules out penalty rates of interest. If the debtor chooses to cure and reinstate the contract, the Bankruptcy Code, since 1994, does not require cure at the high penalty rate. In short, when an oversecured creditor is entitled to pendency interest, it is entitled only to a compensatory, noncontractual rate.

A great many courts now disagree, imposing the contract rate even when it does not represent a proxy for the market rate. These opinions, in my view, ignore Supreme Court rulings to the contrary, and are largely unjustified. Except in the rare case where the debtor is solvent, it is the unsecured creditors who pay the penalty that an oversecured creditor has

272. *In re Lapiana*, 909 F.2d 221, 223 (7th Cir. 1990).

273. 489 U.S. 235 (1989).

274. 508 U.S. 464 (1993).

275. 451 B.R. 323 (Bankr. S.D.N.Y. 2011).

276. *Id.* at 331.

277. *See supra* text accompanying notes 61–63.

278. *See id.*

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insinuated into the contract. As a debtor has no incentive to resist this term, bankruptcy law properly erases such clauses from the contract as unfair expropriations by oversecured creditors at the expense of the undersecured or unsecured creditors.

