POSTPETITION INTEREST ON UNSECURED CLAIMS IN THE CASE OF A SOLVENT DEBTOR: TOWARD A MORE CONSISTENT STATUTORY REGIME

ALEXANDER F. PORTER*

I. INTRODUCTION

One important rule of the Bankruptcy Code[1] is that a creditor generally is not entitled to receive interest on a claim that accrues after the date when the bankruptcy petition is filed.[2] As with most general rules, however, there are several exceptions to this ban on postpetition interest, one of which is that postpetition interest may be allowed in certain cases when the debtor is solvent.[3] This exception is expressly codified in § 726(a)(5) of the Code, which evinces a policy in favor of requiring debtors to pay postpetition interest on creditors' claims when the debtor can afford to do so.[4]

At first glance, § 726(a)(5) does not seem confusing at all. It simply

* Class of 2008, University of Southern California Gould School of Law; B.A. 2003, University of San Francisco. Special thanks to Stephan Ray and others at Stutman, Treister & Glatt P.C. for their ideas and assistance. Thanks to the members of the *Southern California Law Review* for their hard work. And, of course, thanks to my family for their enduring support.

1. The Bankruptcy Code consists of 11 U.S.C. §§ 101–1532 (2000). All section references are to Title 11 of the U.S. Code, unless otherwise noted.

2. *See* 11 U.S.C. § 502(b)(2).

3. *See, e.g.*, *id.* § 726(a)(5); Onink v. Cardelucci (*In re* Cardelucci), 285 F.3d 1231, 1234 (9th Cir. 2002). There are two other circumstances where postpetition interest is permitted: (1) when a secured creditor is oversecured, 11 U.S.C. § 506(b), and (2) when a claim is unimpaired under a plan of reorganization, *see id.* § 1124. Although thorough analysis of these additional exceptions is beyond the scope of this Note, reference is made to them on occasion when relevant to the discussion. *See, e.g.*, *infra* note 96 and accompanying text.

4. *See* 11 U.S.C. § 726(a)(5).

says that if there is any property left in the estate at the end of a Chapter 7 liquidation,[5] then the debtor must pay postpetition interest to the creditors.[6] The devil, however, lies in the details. This Note will illustrate that the construction of several individual sections of the Bankruptcy Code and their interaction with other sections of the Code leaves open questions as to whether a debtor must pay postpetition interest when it is solvent, and if so, at what rate. Specifically, the language of § 726(a)(5) is unclear because it says that postpetition interest should be awarded at the "legal rate" when a Chapter 7 debtor is solvent but does not specify what the legal rate is.[7] Furthermore, the mechanism by which § 726(a)(5) becomes applicable to Chapter 11 cases[8] through the "best-interest-of-creditors" test[9] has the potential to create inconsistent results because when a Chapter 11 debtor is reorganization solvent but liquidation insolvent, the debtor is not required to pay postpetition interest.[10] Add into the mix recent decisions where courts have awarded postpetition interest at the default contract rate pursuant to the "fair and equitable" requirement of § 1129(b),[11] and the answer to whether postpetition interest should be awarded, and at what rate, becomes even less clear.[12]

In Part II, this Note will describe the provisions of the Bankruptcy Code, and notable court decisions interpreting those provisions, that affect the allowance of postpetition interest in the case of a solvent debtor. In Part III, this Note will show how the current statutory regime has created three areas in which it is unclear whether postpetition interest is required in the case of a solvent debtor, and if so, at what rate. In Part IV, this Note will argue that Congress did not specifically intend to create these areas of uncertainty and potential for inconsistent results. Nor are these areas of uncertainty desirable because they have been a source of unnecessary litigation and conflict that does not further any legitimate purpose of the Bankruptcy Code. Finally, in Part V, this Note will propose a few simple amendments to the Code that Congress should adopt in order to lend clarity to the areas of uncertainty created by the current statutory regime and provide answers to some anticipated questions regarding the proposed

5. *Id.* §§ 701–58.
6. *Id.* § 726(a)(5).
7. *See id.*
8. *Id.* §§ 1101–74.
9. *See id.* § 1129(a)(7)(A).
10. *See infra* Part III.B.
11. *See, e.g.*, Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 679 (6th Cir. 2006).
12. *See infra* Part III.C.

amendments.

II. POSTPETITION INTEREST IN THE CASE OF A SOLVENT DEBTOR UNDER THE CURRENT STATUTORY REGIME

Any discussion of postpetition interest necessarily begins with § 502(b)(2) of the Bankruptcy Code, which provides that claims for "unmatured interest" shall not be allowed.[13] This provision of the Code effectively prevents a creditor from including postpetition interest in its claim against the debtor because, by definition, postpetition interest has not matured by the date of the bankruptcy petition.[14] Congress enacted § 502(b) in part to avoid the administrative inconvenience of having to continually compute the interest that would accrue on each individual claim throughout the life of the bankruptcy.[15] Thus, § 502(b) seemingly creates a bright-line rule establishing that postpetition interest is never allowed under the Bankruptcy Code.

One exception to § 502(b)'s general ban on postpetition interest, however, is § 726(a)(5).[16] Section 726 describes the order of distribution of the estate property in a Chapter 7 case.[17] It provides that, once all of the allowed claims are paid in full, the debtor must then pay "interest at the legal rate from the date of the filing of the petition" on any claims against the estate.[18] Simply put, pursuant to § 726(a)(5), if there is property remaining in the estate after a Chapter 7 debtor has been liquidated, and all of the allowed claims have been paid in full, then the debtor must pay postpetition interest to unsecured creditors at the legal rate.[19] There is a notable lack of legislative history regarding what Congress intended the

13. 11 U.S.C. § 502(b)(2).

14. *See* 4 COLLIER ON BANKRUPTCY ¶ 502.03[3][a] (Alan N. Resnick et al. eds., 15th ed. rev. 2005).

15. *See In re* Fesco Plastics Corp., 996 F.2d 152, 155 (7th Cir. 1993) ("One justification for [§ 502(b)(2)] is that it promotes certainty and eases the administration of the estate by fixing a date when the affairs of the bankrupt are considered to be wound up. By setting a date when interest stops, the rule saves the trustee from having to continuously recalculate the amount due each creditor." (internal citation omitted)); 4 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 502.03[3][a] ("[F]ixing the cutoff point for the accrual of interest as of the date of the filing of the petition is a rule of convenience providing for equity in distribution.").

16. *See* 11 U.S.C. § 726(a)(5).

17. *Id.* § 726. Proceeds from a Chapter 7 liquidation are distributed first to priority claims under § 507; second to timely and certain tardily filed unsecured claims; third to unsecured claims tardily filed with knowledge or notice; fourth to fines, penalties, and damages not compensating a loss; fifth to postpetition interest; and finally, any surplus goes to the debtor. *Id.* § 726(a).

18. *Id.* § 726(a)(5).

19. *See id.*

legal rate to be,[20] which, as we will see, has led courts to define the legal rate in a variety of ways in different cases.[21]

Although on its face § 726(a)(5) appears to apply only in Chapter 7 cases, § 726(a)(5) is made applicable to Chapter 11 reorganizations through the best-interest-of-creditors test of § 1129(a)(7).[22] The best-interest-of-creditors test states that a court shall confirm a plan only if each holder of an impaired claim or interest either accepts the plan or will "retain under the plan . . . property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date."[23] Since § 726 details the order of distribution in a Chapter 7 case, it is made applicable to a Chapter 11 case through the best-interest-of-creditors test. Plainly stated, if an individual creditor does not consent to the plan, then the creditor must receive the same amount under the plan that it would receive if the debtor were to be liquidated.[24] Thus, if liquidation of the debtor would produce a surplus, then the Chapter 11 plan must provide for interest "at the legal rate" described in § 726(a)(5).[25]

The analysis with respect to § 726(a)(5) and its application to Chapter 11 through the best-interest-of-creditors test is relatively straightforward when the court defines the legal rate. A less straightforward avenue for awarding postpetition interest in the case of a solvent debtor, however, has been developed by courts that have held that in order for a plan to be fair and equitable under § 1129(b), the plan should provide for postpetition interest.[26] This avenue for the allowance of postpetition interest is not as simple as § 726(a)(5) and the best-interest-of-creditors test because it

20. *See* Onink v. Cardelucci (*In re* Cardelucci), 285 F.3d 1231, 1234 (9th Cir. 2002) (noting the "paucity of legislative history regarding" § 726(a)(5)).

21. *See, e.g.*, *In re* Carter, 220 B.R. 411, 417 (Bankr. D. N.M. 1998) (holding that the appropriate rate of interest was the contract rate); Kellogg v. United States (*In re* W. Tex. Mktg. Corp.), 155 B.R. 399, 402 (Bankr. N.D. Tex. 1993) (applying interest at the rate specified by Texas statute); *In re* Godsey, 134 B.R. 865, 867–68 (Bankr. M.D. Tenn. 1991) (applying interest at the federal judgment rate).

22. *See* 11 U.S.C. § 1129(a)(7)(A). Section 1129(a) lists the requirements for a consensual confirmation. *Id.* § 1129(a).

23. *Id.* §1129(a)(7).

24. *See id.*

25. *See id.* It is conceptually possible that every single creditor in a class could consent to a plan, therefore excepting the plan from providing at least what the creditor would receive in a Chapter 7 liquidation. As a practical matter, however, since it takes only one dissenting creditor to trigger the best-interest-of-creditors test, nearly every plan of reorganization provides for this baseline requirement.

26. *See, e.g.*, *In re* Dow Corning Corp. (*Dow II*), 244 B.R. 678, 695–96 (Bankr. E.D. Mich. 1999).

requires courts to decide what rate of interest would be fair and equitable.[27] Notably, § 1129(b) makes no express mention of postpetition interest in the case of a solvent debtor.[28] Nevertheless, some courts have held that a plan must provide for postpetition interest when a debtor is solvent in order for the plan to be deemed fair and equitable.

In order to understand the approach used by these courts, it is necessary to understand the concept of a "cramdown." A cramdown occurs when one or more classes of creditors votes to reject the plan.[29] A court can confirm the plan and "cram it down" on the dissenting class only if the plan does not "discriminate unfairly" and is deemed "fair and equitable" with respect to each impaired class that votes to reject the plan.[30] The Code says that the condition that a plan be fair and equitable requires that each holder of an unsecured claim will receive the allowed amount of its claim, or the holder of a claim junior to the class of unsecured claims will not retain any property under the plan.[31] This is known as the "absolute priority rule."[32] The absolute priority rule essentially says that a plan can be deemed fair and equitable even though the members of a dissenting class of creditors do not receive the full amount of their allowed claims under the plan so long as no junior creditors receive any value.[33]

27. *See* 11 U.S.C. § 1129(b)(2).

28. *See id.*

29. *See* 7 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 1129.04.

30. *See id.* The "unfair-discrimination" test is designed to ensure that a dissenting class is not treated unfairly as compared to other classes of equal rank. *See id.* ¶ 1129.04[3]. This does not mean, however, that every creditor class with the same liquidation preference must receive exactly the same consideration under the plan. *Id.* For example, unsecured creditors can be divided into tort creditors, trade creditors, and bondholders. *Id.* It may be permissible in certain circumstances to classify these creditors separately and to provide for different compensation to each under the plan. *See id.* This discrimination would not necessarily be prohibited. *Id.* The key is that the plan cannot discriminate "unfairly." *Id.* The test for whether a plan discriminates unfairly has taken on several different formulations. *Compare* Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. P'ship (*In re* Ambanc La Mesa Ltd. P'ship), 115 F.3d 650, 656 (9th Cir. 1997) (adopting a four-part test for determination of whether discrimination is unfair), *with In re* Dow Corning Corp., 244 B.R. 705, 710 (Bankr. E.D. Mich. 1999) (adopting a rebuttable presumption standard when a class of the same priority receives a materially lower percentage of recovery or, regardless of the percentage of the recovery, when one class receives a materially greater risk).

31. *See* 11 U.S.C. § 1129(b)(2)(B).

32. *See* 7 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 1129.04[4][a][i].

33. *See id.* One possible exception to the absolute priority rule is known as the "new value" exception. Although the Supreme Court has never expressly confirmed the existence of the exception, some lower courts have implicitly recognized its existence. *See, e.g.*, *In re* Woodbrook Assocs., 19 F.3d 312, 319–20 (7th Cir. 1994). Under the new value exception, old equity holders can participate in the reorganization without full compensation to the dissenting creditors if the equity holders make a new contribution "(1) in money or money's worth, (2) that is reasonably equivalent to the value of the new equity interests in the reorganized debtor, and (3) that is necessary for implementation of a feasible reorganization plan." *Id.*

Since the adoption of the Bankruptcy Code in 1978, there have been few cases where courts have held that postpetition interest can be paid to unsecured creditors of a solvent debtor under the fair and equitable provision of § 1129(b).[34] Illustrative of the approach taken by the few courts to adopt this approach is a series of opinions arising out of product liability litigation against the breast-implant manufacturer Dow Corning and its subsequent Chapter 11 bankruptcy filing.[35] The *Dow* cases were unique because the debtor was fully solvent when it filed its petition in 1995, it remained solvent throughout the reorganization, and never disputed its ability to pay all of its creditors.[36] The purpose of Chapter 11 was to facilitate "prompt and uniform settlement of the numerous breast-implant-related lawsuits" against the debtor pending at the time of the filing.[37]

In the first of the opinions, *In re Dow Corning Corp.* ("*Dow I*"), the bankruptcy court was faced only with the issue of what the legal rate is under § 726(a)(5).[38] After a thorough analysis, the court determined that the legal rate should be interpreted as the federal judgment rate as defined by 28 U.S.C. § 1961(a).[39] As a result of the court's decision, the debtor provided for postpetition interest in the plan at the federal judgment rate.[40] A class of unsecured creditors voted to reject the plan, however, thereby requiring the debtor to proceed via the cramdown provision of § 1129(b).[41]

The case came before the bankruptcy court again a few months later in *In re Dow Corning Corp.* ("*Dow II*").[42] This time the dissenting class argued that the plan provision providing postpetition interest at the federal

For an examination of the history of the absolute priority rule, including its roots in fraudulent-conveyance law, see Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 74–90 (1991).

34. *See* Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 679–80 (6th Cir. 2006); *Liberty Nat'l Enters.*, 115 F.3d at 654 (holding that a plan violated the absolute priority rule because it did not provide for interest on creditors' unsecured claims, but not specifying the appropriate rate of interest); *Dow II*, 244 B.R. 678, 687 (Bankr. E.D. Mich. 1999).

35. *See In re Dow Corning Corp.*, 456 F.3d at 679–80; *Dow II*, 244 B.R. at 687; *In re* Dow Corning Corp. (*Dow I*), 237 B.R. 380 (Bankr. E.D. Mich. 1999).

36. *See In re Dow Corning Corp.*, 456 F.3d at 671.

37. *Id.* During the 1970s and 1980s, Dow Corning sold more than one million silicone breast implants, making it the largest breast-implant manufacturer and supplier. Barnaby J. Feder, *Dow Corning in Bankruptcy over Lawsuits*, N.Y. TIMES, May 16, 1995, at A1. The plaintiffs who filed claims against Dow Corning reported ruptured or leaking implants that allegedly caused various autoimmune diseases. *Id.*

38. *See Dow I*, 237 B.R. at 385.

39. *See id.* at 412.

40. *See Dow II*, 244 B.R. at 680.

41. *See id.*

42. *Id.*

judgment rate was not fair and equitable under § 1129(b) because the plan only provided for interest at the federal judgment rate, not at the rates that creditors had bargained for in their contracts with the debtor.[43] The court began its analysis by affirming its prior decision that the legal rate under § 726(a)(5) was indeed the federal judgment rate.[44] However, the court reasoned that § 726(a)(5), as made applicable to Chapter 11 cases through the best-interest-of-creditors test, "simply establishes a *minimum* payment requirement" in a Chapter 11 cramdown case.[45] The court reasoned that if Congress had "intended to supplant the contractual right to interest with the [federal judgment rate], one would expect that intention to be plainly expressed."[46] Since no such expression exists, the court refused to infer that Congress had intended to preclude creditors from being paid at a higher rate in the context of a cramdown.[47]

Going on to consider whether the fair and equitable provision of § 1129(b) allows for postpetition interest at a rate higher than the federal judgment rate, the court put much emphasis on the fact that § 1129(b)(2) uses the word "includes" when it describes the conditions that make a plan fair and equitable.[48] Therefore, the court did not put much weight on the fact that § 1129(b) makes no mention of postpetition interest.[49] Instead, the court reasoned that since the word "includes" is not limiting, postpetition interest could be allowed in certain circumstances.[50] The court held that the contract rate of interest should be awarded for the simple reason that "[a] debtor with the financial wherewithal to honor its contractual commitments should be required to do so."[51] The court thereafter sustained the creditors' objection and verbally amended the plan to provide interest at the nondefault rates established in the contracts between the creditors and the debtor.[52]

The unsecured creditors were not satisfied with their victory, however, and they appealed the court's decision on the grounds that they should have

43. *See id.* at 680–81.
44. *Id.* at 686.
45. *Id.*
46. *Id.*
47. *See id.*
48. *See id.* at 690.
49. *See id.* at 690–91.
50. *See id.* at 692.
51. *Id.* at 695.
52. *See id.* It made no difference to the court that a vast majority of the objecting class had acquired their claims at a discount after the filing of the petition. *Id.* The court noted that there was no allegation that the claimants had acquired the claims improperly, and therefore held that they had the same contractual rights as the original claim holders. *Id.* at 696.

been awarded interest at the default rate of interest specified in their contracts with the debtor, not at the nondefault rate specified in the contracts as of the petition date.[53] The appeal was taken up by the Court of Appeals for the Sixth Circuit in *Official Committee of Unsecured Creditors v. Dow Corning Corp.* ("*Dow III*").[54] The creditors argued that the bankruptcy court's decision not to give effect to the default provisions of the contracts violated the absolute priority rule because junior interest holders, the Dow Corning shareholders, stood to retain millions of dollars while the creditors in the dissenting class would not be paid the full amount of their claims.[55] The court noted that although the absolute priority rule applies with equal force when the debtor is solvent, it "imposes somewhat different requirements when a solvent debtor seeks confirmation of its plan."[56] The court also noted legislative history that said, "'in order for a plan to be fair and equitable, unsecured and undersecured creditors' claims must be paid in full, including postpetition interest, before equity holders may participate in any recovery.'"[57]

Going on to consider whether default interest rates may be permitted under the fair and equitable standard, the court noted that rather than considering equitable principles, courts have enforced creditors' prepetition rights against the debtor.[58] The court reasoned that "[d]efault interest rates are intended to transfer some of the risk of default from creditors to the debtor."[59] Therefore, if the court awarded interest at the nondefault rate, it would be shifting that risk back to the creditor—a move that would vitiate the creditors' contractual rights.[60] Thus, the court said "absent compelling equitable considerations, when a debtor is solvent, it is the role of the

53. *See* Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 671 (6th Cir. 2006).

54. *Id.*

55. *Id.* at 678.

56. *Id.*

57. *Id.* (quoting 140 CONG. REC. H10,768 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks)). It is interesting to note that this statement from Representative Brooks was made in 1994, not in 1978 when the Bankruptcy Code was originally enacted. Also notable is that the cases cited in support of this statement were all decided under the preceding Bankruptcy Act. *See* Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 527 (1941), *superseded by statute*, Bankruptcy Code, 11 U.S.C. §§ 101–1532 (2000); Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp., 679 F.2d 264, 269 (1st Cir. 1982) (applying pre-Code law even though it was decided four years after passage of the Bankruptcy Code). The statement was made when referring to an amendment to § 1124, which changed the rules regarding impairment giving creditors the right to vote for or against a plan with the hope of receiving postpetition interest when the debtor is solvent. 140 CONG. REC. H10,768 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks).

58. *In re Dow Corning Corp.*, 456 F.3d at 679.

59. *Id.*

60. *See id.*

bankruptcy court to enforce the creditors' contractual rights."[61] Because the record before the court was not sufficiently developed to make a finding on any other relevant equitable factors, however, the court remanded the case to the bankruptcy court to make a final determination as to the appropriate rate of interest.[62]

The rulings in *Dow II* and *III* were met with commentary and criticism in the legal community because the decisions opened up the possibility that unsecured creditors could receive postpetition interest at alarmingly high rates.[63] One commentator noted the importance of the decisions and the fact that solvent debtor bankruptcies could be quite profitable for unsecured creditors with high default rates of interest in their contracts with the debtor.[64] Other commentators criticized the decision in the *Dow II* and *III* cases, finding error with the court's reasoning.[65] They argued that the court's decision in *Dow III* lacked a firm textual basis in the Code and that it conflicted with the court's earlier ruling that the Code limits the court's equitable powers when determining whether, and at what rate, postpetition interest should be awarded.[66]

In one article, the authors argued that the *Dow II* court's decision was flawed because it failed to consider the rights of junior dissenting classes.[67] The authors argued that if there had been a junior dissenting class, then the court's decision would have violated the guarantee to junior classes that creditors with a higher priority will only receive interest at the legal rate pursuant to § 1129(a)(7).[68] They also asserted that the court arguably erred in concluding that the use of the term "includes" in § 1129(b) allows the

61. *Id.*

62. *Id.* at 680.

63. *See* Carmen H. Lonstein & Steven A. Domanowski, *Payment of Post-Petition Interest to Unsecured Creditors: Federal Judgment Rate Versus Contract Rate*, 12 AM. BANKR. INST. L. REV. 421, 437 (2004); *Sixth Circuit Finds Default in Dow Corning's Argument*, BANKR. UPDATE (Akin Gump Strauss Hauer & Feld LLP, Dallas, Tex.), Dec. 2006, at 7 [hereinafter *Sixth Circuit Finds Default*]; *Sixth Circuit Weighs in on Debate Over the Payment of Postpetition Interest to Unsecured Creditors in Chapter 11 when Debtor Is Solvent*, INSOLVENCY NOTES (White & Case LLP, New York, N.Y.), Aug. 2006, at 1 [hereinafter *Sixth Circuit Weighs in on Debate*]; *The Sixth Circuit Rules that Unsecured Creditors of a Solvent Debtor Are Entitled to Pendency Interest at the Contractual Default Rate and Reimbursement of Expenses*, CORP. RESTRUCTURING & BANKR. UPDATE (Kramer Levin Naftalis & Frankel LLP, New York, N.Y.), Dec. 1, 2006, at 2.

64. *See Sixth Circuit Finds Default*, *supra* note 63, at 8.

65. *See* Lonstein & Domanowski, *supra* note 63, at 436–38; *Sixth Circuit Weighs in on Debate*, *supra* note 63, at 6.

66. *See Sixth Circuit Weighs in on Debate*, *supra* note 63, at 6.

67. *See* Lonstein & Domanowski, *supra* note 63, at 436.

68. *See id.* at 436. The rule that the authors refer to is an uncodified element of the absolute priority rule, which states that creditors in classes senior to the dissenting class should not receive more than 100 percent of their claims. *See* 7 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 1129.04[4][a][ii].

court to add a requirement to what makes a plan fair and equitable.[69] Furthermore, the authors pointed out that the court had essentially adopted a "balancing-of-the-equities" test similar to the pre-Code practice that has since been roundly rejected by other courts.[70]

The legal community's criticism of the *Dow II* and *III* decisions reveals that it is far from settled that postpetition interest should be awarded pursuant to the fair and equitable provision of § 1129(b). The disquietude in the legal community on the issue appears to be due, at least in part, to the perception that the *Dow II* and *III* courts were motivated to pay interest at a higher rate because of a general concern for fairness instead of a firm textual foundation in the Code. In *Dow III*, the court went out of its way to emphasize the fact that the debtor was quite solvent and that there was more than $1 billion in unsecured claims that was not receiving its contractual rate of interest throughout the life of the bankruptcy.[71] It appears that the courts thought it was unfair that the debtor was using the bankruptcy process to pay interest to its creditors at a lower rate. In order to remedy the situation, the courts read a previously nonexistent requirement of postpetition interest into the fair and equitable standard of § 1129(b).[72]

Whether the court's decision to read a requirement of postpetition interest into § 1129(b)'s fair and equitable provision was the correct decision is debatable. Although the court may have considered it unfair that the debtor entered bankruptcy as a solvent entity, there is no provision in the Bankruptcy Code that requires a debtor to be insolvent before it files for bankruptcy.[73] A court maintains the ability, however, to dismiss a bankruptcy case if it feels that the petition was filed in bad faith.[74] In the

69. *See* Lonstein & Domanowski, *supra* note 63, at 438.

70. *See id.* at 438–39.

71. *See* Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 671 (6th Cir. 2006).

72. *See id.* at 678; *Dow II*, 244 B.R. 678, 696 (Bankr. E.D. Mich. 1999).

73. *See* 2 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 101.13.

74. *See* 7 *id.* ¶ 1112.07. The many circumstances in which good faith has been found to be lacking include:

> (1) use of bankruptcy as a vehicle to defraud others, (2) the persistent failure to comply with applicable court orders, rules, or procedures, (3) use of the bankruptcy process to escape familial obligations, (4) the secretion of property and other efforts to avoid the disclosure of assets, (5) use of the bankruptcy system simply to avoid the consequences of prior misconduct, (6) the filing of a case to avoid an obligation under circumstances in which the debtor is not in need of reorganization, (7) the absence of legitimate debt, (8) the absence of any likelihood of rehabilitation, (9) use of bankruptcy as a vehicle to resolve disputes solely between equity participants, (10) use of the bankruptcy process merely to frustrate the rights of creditors . . . or to coerce unfair treatment, (11) successive filings without any change in financial condition, and (12) the so-called new debtor syndrome, in which a debtor is created, or property is transferred, solely for the purpose of commencing a bankruptcy case.

Dow II and *III* decisions, it seems that the courts felt there was bad faith due to the fact that the debtor filed for bankruptcy in order to settle the product-liability lawsuits, not because the debtor was facing imminent insolvency. But if this is how the court felt, perhaps it should have made a finding of bad faith instead of creating a new exception for postpetition interest.

Nevertheless, it remains to be seen whether other circuits will adopt the same reasoning as the Sixth Circuit. Until other circuits address the issue, it will remain unclear whether the fair and equitable provision of § 1129(b) requires—or even allows—postpetition interest in the case of a solvent debtor, and if so, at what rate.[75]

III. UNCERTAINTY AND POTENTIAL FOR INCONSISTENT OUTCOMES CREATED BY THE CURRENT STATUTORY REGIME

As the preceding section illustrated, postpetition interest can be awarded in three different ways to unsecured creditors when a debtor is solvent: (1) in a Chapter 7 case pursuant to § 726(a)(5); (2) in a Chapter 11 case where § 726(a)(5) is made applicable through the best-interest-of-creditors test of § 1129(a)(7); and (3) although not yet widely adopted by courts, in a Chapter 11 cramdown over the objections of a dissenting class in order to make the plan fair and equitable pursuant to § 1129(b). The following discussion explains how the ambiguous wording of § 726(a)(5) and the way that it interacts with other sections of the Code creates three areas of uncertainty with regard to when, and at what rate, postpetition interest should be awarded when a debtor is solvent. This uncertainty has the potential to create inconsistent and unpredictable outcomes to such an extent that Congress should amend the Code to clarify precisely when and at what rate postpetition interest should be awarded in the case of a solvent debtor.

A. AMBIGUOUS DEFINITION OF THE LEGAL RATE OF § 726(A)(5)

The most glaring and well-documented problem with the current

Id. ¶ 1112.07[7] (internal footnotes omitted). Indeed, courts have dismissed Chapter 11 cases for lack of good faith because the debtor was solvent and civil liability was not certain and imminent. *Id.* (citing *In re* SGL Carbon Corp., 200 F.3d 154, 165–66 (3d Cir. 1994)).

75. The only other federal appeals court that has awarded postpetition interest pursuant to § 1129(b) is the Ninth Circuit. *See* Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. P'ship (*In re* Ambanc La Mesa Ltd. P'ship), 115 F.3d 650, 654 (9th Cir. 1997) (holding that a plan violated the absolute-priority rule because it did not provide for interest on the creditor's unsecured claim, but not specifying the appropriate rate of interest).

statutory regime is that the legal rate of § 726(a)(5) is not clearly defined.[76] The ambiguous wording of § 726(a)(5) has spawned numerous judicial decisions in which courts have come to contrary conclusions with regard to the definition of the legal rate.[77] The two conflicting approaches taken by courts are often referred to as the "state law approach" and the "federal-judgment-rate approach."[78] Courts adopting the state law approach apply interest at the rate specified in an existing contract between the creditor and the debtor or at the rate specified by an applicable state statute.[79] Courts adopting the federal-judgment-rate approach apply interest at the rate specified by 28 U.S.C. § 1961(a), the rate at which interest is awarded on the delay in payment of federal court judgments.[80] Numerous courts and commentators have confronted the various rationales for both of these approaches.[81]

The problem with the lack of clarity in the statute is that any time there is a solvent Chapter 7 or Chapter 11 debtor, the parties engage in contentious litigation in order to determine what approach the court should use. Since very few federal appeals courts have decided the issue,[82] occasionally bankruptcy courts in the same district, or even the same bankruptcy court itself, have applied different rates in different cases.[83]

76. *See* 11 U.S.C. § 726(a)(5) (2000).

77. *See, e.g.*, *In re* Carter, 220 B.R. 411, 417 (Bankr. D. N.M. 1998) (holding that the appropriate rate of interest was the contract rate); Kellogg v. United States (*In re* W. Tex. Mktg. Corp.), 155 B.R. 399, 402 (Bankr. N.D. Tex. 1993) (applying interest at the rate specified by Texas statute); *In re* Godsey, 134 B.R. 865, 867–68 (Bankr. M.D. Tenn. 1991) (applying interest at the federal judgment rate).

78. *See* Beguelin v. Volcano Vision, Inc. (*In re* Beguelin), 220 B.R. 94, 99 (B.A.P. 9th Cir. 1998).

79. *See id.*

80. *See id.*

81. *See, e.g.*, Onink v. Cardelucci *(In re* Cardelucci), 285 F.3d 1231, 1234–36 (9th Cir. 2002); *Dow I*, 237 B.R. 380, 394–412 (Bankr. E.D. Mich. 1999); Lonstein & Domanowski, *supra* note 63, at 424–34.

82. It appears that of all the circuits, only the Ninth Circuit has unequivocally defined the legal rate. *See In re Cardelucci*, 285 F.3d at 1233 (defining the legal rate as the federal judgment rate). In *Dow III*, the Sixth Circuit affirmed the bankruptcy-court ruling that interest should be awarded in order to make the plan fair and equitable, but it did not address whether the bankruptcy court was correct in holding that the legal rate is the federal judgment rate. *See* Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 679–80 (6th Cir. 2006).

83. For example, in *In re Shaffer Furniture Co.*, the bankruptcy court adopted the state law approach and held that postpetition interest should be awarded at the state statutory rate. *In re* Shaffer Furniture Co., 68 B.R. 827, 831 (Bankr. E.D. Pa. 1987), *abrogated by In re* Chiapetta, 159 B.R. 152, 160 (Bankr. E.D. Pa. 1993). Six years later in a different case, the same bankruptcy judge changed course and awarded postpetition interest at the federal judgment rate. *In re Chiapetta*, 159 B.R. at 160. Explaining his change of position, the judge said that the federal judgment rate was not an option proposed by the parties in *Shaffer*. *Id.*

This creates a lack of predictability and inconsistent results. The inconsistent results not only affect solvent Chapter 7 cases, but also Chapter 11 cases as well, since § 726 is made applicable to Chapter 11 cases through the best-interest-of-creditors test of § 1129(a)(7).[84]

B. THE REORGANIZATION SOLVENT BUT LIQUIDATION INSOLVENT DEBTOR

The second problem that the current statutory regime creates is that it is unclear whether postpetition interest is required in a Chapter 11 case when the debtor is reorganization solvent but liquidation insolvent. This problem arises because there are certain circumstances when the reorganization value, or going-concern value, of a debtor would be such that the debtor would be solvent, in the sense that the reorganization value of the company is greater than its liabilities.[85] If the same company were liquidated, however, the debtor would be insolvent.[86] This creates problems determining whether the debtor is required to pay postpetition interest, because the only provision of the Code that expressly requires postpetition interest in the case of a solvent Chapter 11 debtor is § 726(a)(5), as made applicable through the best-interest-of-creditors test.[87] The best-interest-of-

84. *See* 11 U.S.C. § 1129(a)(7) (2000).

85. The Bankruptcy Code defines "insolvent" with respect to an individual or corporation as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." *Id.* § 101(32)(A).

86. This phenomenon occurs because the value that can be obtained for individual assets at a liquidation sale is often less than the fair market value of the entity as a going concern. Issues of valuation are central to any Chapter 11 reorganization and vary depending on the circumstances and the purpose of the valuation:

> The value ascribed to an asset ultimately depends on the assumptions made regarding its use or disposition. For example, if one assumes that the property must be sold on a forced liquidation, the resulting valuation of the asset (often referred to as "liquidation value") may be less than would be the case if one assumes that the property is to be sold at arms' length between a willing buyer and seller, neither being required to sell or buy (often referred to as "fair market value"). Similarly, the method of valuation used to value a business enterprise will depend on whether one assumes a liquidation of assets on a piecemeal basis or its operation as a going concern. In the latter case, the test of value is "going concern value" based on a capitalization of future earnings of the business. Thus, any contest over the appropriate method of valuation to be adopted in any given context will necessarily focus on the assumed use or disposition of the asset that underlies the valuation.

Isaac M. Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C. L. REV. 925, 951 (1980) (internal citation omitted). Determining an enterprise's going-concern value requires the parties in interest to project the enterprise's future income stream and then to determine a discounted present value for that income stream by multiplying the average annual projected income by a multiplier based on an appropriate capitalization rate. *Id.* at 940. The capitalization rate reflects the expected annual rate of return that investors would require on an investment of comparable risk. *Id.* at 940 n.69.

87. *See* 11 U.S.C. § 1129(a)(7).

creditors test would not mandate postpetition interest when the debtor is liquidation insolvent because the test only requires that a creditor receive at least as much as it would if the debtor were liquidated.[88] Since in this case, if the debtor were liquidated the estate would be insolvent, § 726(a)(5) clearly would not mandate interest at the legal rate. Thus, there is no express statutory requirement that the reorganization solvent debtor must pay postpetition interest to its creditors.

One possible solution for this problem, however, is that a court could direct the reorganization solvent but liquidation insolvent debtor to pay postpetition interest in order to satisfy the fair and equitable requirement of § 1129(b). In fact, this appears to be the approach taken by the bankruptcy court in *In re Coram Healthcare Corp*.[89] *Coram Healthcare* is a rare case where the debtor was reorganization solvent but liquidation insolvent.[90] In *Coram Healthcare*, the going-concern value of the company was $317 million but the liquidation value of the company was only $134 million.[91] Since the debtor owed at least $300 million to creditors, the debtor was reorganization solvent but liquidation insolvent.[92] The creditors argued that they were entitled to postpetition interest pursuant to the absolute priority rule codified in § 1129(b).[93] On the other hand, the equity committee argued that the absolute priority rule did not require the payment of postpetition interest because § 502(b) does not include unmatured interest in the amount of a creditor's allowed claim.[94]

The court rejected the equity committee's argument. Citing *Dow II*, the court reasoned that § 502(b)(2) "does not prohibit the award of interest to creditors in all circumstances."[95] The court noted that the Bankruptcy Code provides several exceptions to § 502(b)'s general ban on postpetition interest, including § 506(b) when a creditor is oversecured, § 726(a)(5) and the best-interest-of-creditors test when the debtor is liquidation solvent, and § 1124 when a creditor is unimpaired under a plan.[96] Therefore, the court concluded that "payment of post-petition interest before any distribution to equity holders in a chapter 11 case is not prohibited by the Code and, in

88. *See id.*
89. *In re* Coram Healthcare Corp., 315 B.R. 321 (Bankr. D. Del. 2004).
90. *See id.* at 345.
91. *Id.*
92. *See id.*
93. *See id.* at 343.
94. *See id.* at 343–44.
95. *Id.* at 344.
96. *See id.*

fact, may be required."[97]

Before making its final determination that postpetition interest should be awarded, the court dealt briefly with the reorganization solvent but liquidation insolvent problem.[98] The court seemingly recognized the problem that postpetition interest was not required pursuant to the best-interest-of-creditors test because if the debtor had been liquidated it would have been insolvent.[99] The court summarily concluded, however, that "[i]n this case, though, it is relevant to compare the amount of the debt to the confirmation value . . . because the Debtors are reorganizing instead of liquidating. Under that scenario the Debtors are solvent, and post-petition interest should be paid before shareholders get a distribution."[100] As authority for this statement, the court cited to *In re Cardelucci* and *Dow II*.[101]

It is unclear to what in the Ninth Circuit *Cardelucci* decision the court was citing to support the conclusion that postpetition interest should be awarded in the case of a reorganization solvent but liquidation insolvent debtor; *Cardelucci* makes no mention of either § 1129(b) or the liquidation insolvent problem.[102] One possibility is that the court was citing to the general statement in *Cardelucci* that "[w]here a debtor in bankruptcy is solvent, an unsecured creditor is entitled to 'payment of interest at the legal rate from the date of the filing of the petition' prior to any distribution of remaining assets to the debtor."[103] It is doubtful, however, that this statement from *Cardelucci* provides support for the court's conclusion that interest should be paid if the debtor is reorganization solvent but liquidation insolvent because the *Cardelucci* court clearly quoted from and cited to § 726(a)(5).[104] In fact, § 726(a)(5) is precisely the source of the uncertainty with respect to whether the debtor is required to pay postpetition interest in the *Coram Healthcare* case. In that case, the debtor was liquidation insolvent,[105] but by virtue of its application to Chapter 11 through the best-interest-of-creditors test, § 726(a)(5) did not require interest in the case of a

97. *Id.*

98. *See id.* at 345.

99. *See id.*

100. *Id.*

101. *Id.* (citing Onink v. Cardelucci (*In re* Cardelucci), 285 F.3d 1231, 1234 (9th Cir. 2002); *Dow II*, 244 B.R. 678, 686 (Bankr. E.D. Mich. 1999)).

102. *See In re Cardelucci*, 285 F.3d at 1234.

103. *Id.* (citing 11 U.S.C. § 726(a)(5) (2000)).

104. *Id.*

105. *See In re Coram Healthcare Corp.*, 315 B.R. at 344–45.

liquidation insolvent debtor.[106] It appears, therefore, that *Cardelucci* is not sound authority for the *Coram Healthcare* court's summary conclusion that postpetition interest should be awarded when the debtor is reorganization solvent but liquidation insolvent.

The more authoritative source for the *Coram Healthcare* court's conclusion that postpetition interest should be paid even though the debtor was liquidation insolvent is the court's citation to *Dow II*.[107] A fair interpretation of the *Coram Healthcare* decision is that the court followed the reasoning of the *Dow II* court and found that postpetition interest should be awarded in order to make the plan fair and equitable pursuant to § 1129(b). Therefore, by awarding postpetition interest, the *Coram Healthcare* court solved the reorganization solvent but liquidation insolvent problem by using the broad fair and equitable provision of § 1129(b).

The *Coram Healthcare* decision is instructive because it demonstrates one way that a court could deal with the reorganization solvent but liquidation insolvent problem. Since it is one of the only published opinions to expressly consider the problem, it is especially persuasive. It is unclear, however, whether the *Coram Healthcare* court's approach of using the fair and equitable provision of § 1129(b) to award postpetition interest in the case of a reorganization solvent but liquidation insolvent debtor will significantly reduce the amount of uncertainty that exists with respect to whether postpetition interest should be paid to unsecured creditors in such a case.

One reason why the *Coram Healthcare* decision might not significantly reduce the amount of uncertainty is that, outside of the Sixth Circuit, courts have not yet established to what extent they will award postpetition interest pursuant to § 1129(b) in order to make a plan fair and equitable.[108] As previously discussed, the *Dow II* and *III* decisions are quite recent developments in the law and they have been met with much criticism in the legal community.[109] One could hardly say that these decisions have received widespread acceptance as of yet, and it is not clear whether they will in the future.

Another reason why the *Coram Healthcare* court's approach does not

106. *See* 11 U.S.C. § 1129(a)(7).

107. *See Dow II*, 244 B.R. 678, 696 (Bankr. E.D. Mich. 1999).

108. While it has been established in the Ninth Circuit that the absolute priority rule requires postpetition interest in the case of a solvent debtor, it is still unclear at what rate. *See* Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. P'ship (*In re* Ambanc La Mesa Ltd. P'ship), 115 F.3d 650, 654 (9th Cir. 1997).

109. *See supra* note 63.

make it expressly clear whether postpetition interest should be awarded in the case of a reorganization solvent but liquidation insolvent debtor is that, even if other courts were to widely adopt the *Dow II* and *III* approach of awarding postpetition interest pursuant to the fair and equitable provision of § 1129(b), nothing mandates that courts in fact award postpetition interest under that standard. When all courts have to rely on is the broad standard of fair and equitable, the decision of whether postpetition interest is required comes down to the equities of the case, and there is nothing to mandate that the court award any postpetition interest whatsoever in the case of a reorganization solvent but liquidation insolvent debtor. In essence, relying on fair and equitable makes it clear that postpetition interest is *possible* in the case of a reorganization solvent but liquidation insolvent debtor, but it is far from clear whether postpetition interest is *required* at any rate.[110] Whereas the best-interest-of-creditors test clearly establishes that a creditor is entitled to at least as much in a reorganization as it would have received in a liquidation,[111] awarding postpetition interest pursuant to § 1129(b)'s fair and equitable provision does not provide for such a clearly defined outcome. Indeed, in *Dow II*, the court noted that the fair and equitable inquiry is "as broad as it sounds" giving the court "wide parameters" in determining matters concerning postpetition interest.[112] Therefore, if the award of postpetition interest were left up to an inquiry of whether it is fair and equitable, any number of outcomes would be possible.

In fact, it is possible that a court might not award any postpetition interest at all if only the fair and equitable standard applied, because there is no minimum interest rate required in the case of a reorganization solvent but liquidation insolvent debtor. The *Dow II* decision effectively established a floor with respect to the lowest rate of postpetition interest that can be awarded in the case of a solvent Chapter 11 debtor.[113] Under *Dow II*, the court determined that the floor was the federal judgment rate because the best-interest-of-creditors test made § 726(a)(5) applicable to the liquidation solvent debtor and required that interest be paid at the legal rate, which *Dow I* had determined was the federal judgment rate.[114] The problem with relying on the reasoning of *Dow II* is that in the case of the reorganization solvent but liquidation insolvent debtor, the floor is knocked

110. Except, of course, in the Sixth and Ninth Circuits, where the courts of appeals have said that postpetition interest is required in order to make a plan fair and equitable with respect to a dissenting class of unsecured creditors when the debtor is solvent. *See infra* note 186.

111. *See* 11 U.S.C. § 1129(a)(7).

112. *See Dow II*, 244 B.R. at 694–95.

113. *See id.* at 686.

114. *See id.*

out. The best-interest-of-creditors test no longer establishes the floor because the debtor is liquidation insolvent. The court could award interest based on the fair and equitable provision of § 1129(b), but nothing in § 1129(b) mandates such a result.

In conclusion, the case of a reorganization solvent but liquidation insolvent debtor provides an example of a case where the current statutory framework does not provide a clear answer to whether postpetition interest is allowed, much less whether it is required. The *Coram Healthcare* court's conclusion that postpetition interest should be paid pursuant to the fair and equitable provision of § 1129(b) in the case of a reorganization solvent but liquidation insolvent debtor is instructive because it shows one way that postpetition interest could be awarded, despite the fact that the best-interest-of-creditors test does not mandate such a result.[115] It remains uncertain, however, to what extent the *Coram Healthcare* decision clarifies whether postpetition interest is required in the case of a reorganization solvent but liquidation insolvent debtor because it is uncertain whether other courts would adopt the same approach. Courts might not adopt the same approach that the *Coram Healthcare* court took because it relied on the *Dow II* and *III* decisions, and the reasoning of the *Dow II* and *III* decisions has been widely criticized.[116] Furthermore, even if courts outside the Sixth Circuit were to adopt the reasoning of *Dow II* and *III*, postpetition interest would only be *allowed* in certain circumstances, not *required* in all circumstances.

C. THE DISCRETION GIVEN TO JUDGES TO CHOOSE FROM A BROAD RANGE OF INTEREST RATES CREATES UNPREDICTABLE, INCONSISTENT RESULTS

Although it is still open for debate whether *Dow II* and *III* were correctly decided with respect to whether postpetition interest should be awarded under the fair and equitable requirement of § 1129(b), one thing is certain: the introduction of the possibility of awarding postpetition interest to make a plan fair and equitable gives judges discretion to award postpetition interest from within a broad range of interest rates. This broad range of interest rates undoubtedly has the potential to cause unpredictable and inconsistent results in otherwise similar Chapter 11 cases.

In the simple case of a reorganization and liquidation solvent debtor, creditors would be entitled to interest at the legal rate by virtue of the best-

115. *See In re* Coram Healthcare Corp., 315 B.R. 321, 345 (Bankr. D. Del. 2004).

116. *See supra* note 63.

interest-of-creditors test.[117] Assuming that the legal rate is defined as the federal judgment rate,[118] the floor on the rate of interest would most likely be quite low. In July 2008, the federal judgment rate was approximately 4 percent.[119] The introduction of the fair and equitable approach, and the *Dow III* court decision that postpetition interest could be awarded at the default contract rate, opened up the possibility of awarding interest to unsecured creditors at soaring interest rates.[120] If the court decides that the equities do in fact allow for interest at the default contract rate, the rate of interest could be quite high. It is conceivable that contracts between the debtor and creditors could provide for interest at default rates up to 20 percent.[121] The only restriction on the court's discretion would be to make sure that the default rate is not usurious.[122] Therefore, the rate at which postpetition interest could be awarded could range from as low as 4 percent to as high as 20 percent—a spread of 16 percent. When there are billions of dollars in unsecured claims, there almost certainly would be a protracted dispute about the appropriate rate for postpetition interest because hundreds of millions of dollars would be on the line. The only guidance to the court's decision would be whether the rate it chooses is fair and equitable.

An even more dramatic illustration of the breadth of the court's discretionary power to award postpetition interest is the situation of a reorganization solvent but liquidation insolvent debtor. As discussed previously, nothing in the Code currently requires such a debtor to pay postpetition interest to its creditors at the federal judgment rate because the best-interest-of-creditors test does not apply to a reorganization solvent but liquidation insolvent debtor.[123] The fair and equitable standard, however, opens up the possibility that if a class of unsecured creditors votes to reject the plan, the court might decide that postpetition interest should be paid.[124] As the *Dow III* case illustrates, under the fair and equitable standard,

117. *See* 11 U.S.C. § 1129(a)(7) (2000).

118. The current trend is to define the legal rate as the federal judgment rate. *See infra* note 172 and accompanying text.

119. *See* Federal Reserve Statistical Release, Selected Interest Rates, http://www.federalreserve.gov/releases/h15/ (last visited Sept. 9, 2008) [hereinafter Selected Interest Rates] (providing the rate for the ten-year Treasury Constant Maturity Bond, the federal judgment rate).

120. *See* Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 680 (6th Cir. 2006).

121. Although none of the *Dow* decisions explicitly state what the default interest rate was, in *Coram Healthcare* the default interest rate was 15 percent. *In re* Coram Healthcare Corp., 315 B.R. 321, 347 (Bankr. D. Del. 2004). Especially in today's tight credit market, it is conceivable that default rates in other cases could be as high as 20 percent.

122. *See* 4 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 502.03[2][b][ii].

123. *See supra* Part III.B.

124. *See, e.g.*, *Dow II*, 244 B.R. 678, 696 (Bankr. E.D. Mich. 1999).

interest could be paid as high as the default contract rate.[125] Therefore, hypothetically, a court would have the discretion to award interest anywhere from 0 percent at the low end to 20 percent at the high end—a spread of 20 percent. This creates an even broader range of potential interest rates than in the case of a reorganization and liquidation solvent debtor.

In conclusion, the introduction of the possibility that postpetition interest can be awarded in order to make a plan fair and equitable, gives judges discretion to award interest within an alarmingly broad range of rates. This broad range of rates can mean the difference of hundreds of millions of dollars in recovery to creditors. The potential for inconsistent or unpredictable results in otherwise similar Chapter 11 cases is high because the range of rates is so broad and the only standard guiding a given judge's decision is whether the rate is fair and equitable.

IV. CONGRESSIONAL INTENT AND THE DESIRABILITY OF THE RESULTING OUTCOMES

A. CONGRESS'S INTENT WITH RESPECT TO THE AREAS OF UNCERTAINTY AND THE POTENTIAL FOR INCONSISTENT RESULTS

Given the three identified areas of uncertainty with respect to whether postpetition interest is required, and at what rate, when a debtor is solvent, it is necessary to consider whether Congress intended to create such uncertainty and the potential for inconsistent results. Legislative intent is important because bankruptcy law is defined by the Bankruptcy Code.[126] Courts obviously play a vital role in interpreting the Code, but much of the interpretive process amounts to discerning the legislative intent.[127] Thus, if lawmakers anticipated and intended the various inconsistent outcomes of the Code, there would be little reason to advocate amending the Code. In the cases of the three areas of uncertainty with respect to the allowance of

125. *See In re Dow Corning Corp.*, 456 F.3d at 680.

126. *See* Richard I. Aaron, *The Bankruptcy Reform Act of 1978: The Full-Employment-for-Lawyers Bill*, 1979 UTAH L. REV. 1, 22 (noting that "legislative intent will be important in construing the statute"). *See also* 1 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 1.01[1].

127. "Courts and legal scholars often look to the legislative history of the [Bankruptcy Reform Act of 1978] in order to determine the precise meaning of certain words or provisions." Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DEPAUL L. REV. 941, 942 (1978). Interpretation of such legislative intent can be challenging, however, because the Bankruptcy Reform Act of 1978 was the product of ten years of work involving hundreds of participants and many congressional hearings. *Id. See also* Zuber v. Allen, 396 U.S. 168, 186 (1969) (noting that committee reports on bankruptcy bills provide the most authoritative statement of the legislature's intent).

postpetition interest to solvent debtors, however, it is unlikely that Congress intended to create such uncertainty.

First of all, it probably is not the case that Congress intended to create such conflicting decisions among the courts when it created § 726(a)(5), mandating that interest should be awarded at the legal rate in the case of a surplus. In fact, it is likely that Congress intended the exact opposite. Although courts have noted "a paucity of legislative history" on the matter,[128] it is unlikely that Congress intended for courts to differ in their interpretation of what the legal rate means. The construction of § 726(a)(5) itself indicates that Congress intended for only one rate of interest to be used.[129] As several courts and commentators have noted, Congress decided to use the definite article "the," instead of the indefinite "a" or "an," to precede the ambiguously defined legal rate.[130] Courts have interpreted the use of the definite article to indicate that Congress intended for a single source to define the rate at which postpetition interest should be calculated.[131] Furthermore, in *Dow I*, Judge Spector commented that he believed Congress hoped to eliminate a "haphazard subjective method for determining post-petition interest . . . when it enacted § 726(a)(5)."[132]

Secondly, nothing in the legislative history suggests that Congress intended to create uncertainty about whether postpetition interest is required when a debtor is reorganization solvent but liquidation insolvent.[133] It is unclear from the legislative history whether Congress contemplated the possibility of such a debtor, much less whether postpetition interest should be paid in that scenario. Since it is a relatively obscure factual occurrence, it is not surprising that the legislative history reveals no indication that Congress specifically contemplated the possibility that a creditor of a reorganization solvent but liquidation insolvent debtor might not receive any postpetition interest on its claim.

Finally, Congress probably did not intend to create the possibility of inconsistent and unpredictable outcomes resulting from the discretion given

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

129. *See id.*

130. *See, e.g.*, *id.* at 1234–35; Lonstein & Domanowski, *supra* note 63, at 426–27.

131. *See, e.g.*, *In re Cardelucci*, 285 F.3d at 1234.

132. *Dow I*, 237 B.R. 380, 396 n.11 (Bankr. E.D. Mich. 1999).

133. While it is always difficult to prove a negative, review of many different sources of legislative history reveals that Congress did not consider the issue. *See* H.R. REP. NO. 95-595 (1977); H.R. DOC. NO. 93-137 (1973); S. REP. NO. 95-989 (1978); 124 CONG. REC. S17403–34 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini); 124 CONG. REC. S17403–34 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini); 124 CONG. REC. H11047-11117 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards).

to judges to award postpetition interest within a broad range of rates. There is no indication from the legislative history that Congress thought giving judges such a broad range of rates from which to choose would be desirable.[134] There is also no indication that Congress specifically intended to create what have subsequently become the low and high ends of the range within which judges have discretion to choose. On the low end of the range, for instance, the legislative intent behind the phrase "legal rate" is unclear.[135] Additionally, as discussed above, it is not clear whether Congress intended for postpetition interest to be paid at all in the case of a reorganization solvent but liquidation insolvent debtor.

On the high end of the range, it is similarly unclear to what extent Congress intended for postpetition interest to be awarded under the fair and equitable provision of § 1129(b). It is through the fair and equitable avenue that courts have held that judges can award interest as high as the default rate of interest defined in the contract.[136] Although some legislative history suggests that Congress intended for the pre-Code practice of awarding postpetition interest under the fair and equitable provision to survive,[137] it is not evident from that legislative history whether Congress intended for interest awarded under the provision to be at the contract rate, much less at the default rate of interest in the contract between the debtor and the creditor.

Dow III is the only case since the enactment of the Code to endorse the possibility that interest could be awarded at a high default rate of interest.[138] In that case, the court noted the statement in the legislative history that "courts have held that where an estate is solvent, in order for a plan to be fair and equitable, unsecured and undersecured creditors' claims must be paid in full, including postpetition interest, before equity holders may participate in recovery."[139] The court's conclusion, however, that postpetition interest could be awarded at the nondefault contract rate or at the default contract rate does not necessarily follow from this statement of

134. *See supra* note 133.

135. As discussed later, the *Dow I* court found that an article written by one of the people involved with writing the Code implied that legislators had intended for the legal rate to be the federal judgment rate. *See infra* note 183. At best, however, the *Dow I* court's conclusion would be considered secondhand knowledge of legislative intent. There is no clear statement of legislative intent with respect to the meaning of the legal rate in the legislative history.

136. *See* Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 680 (6th Cir. 2006).

137. *See id.* at 678.

138. *See id.* at 680.

139. *Id.* at 678 (quoting 140 CONG. REC. H10,768 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks)).

legislative intent. It seems relatively clear that Congress intended for postpetition interest to be paid under the fair and equitable provision, but Congress did not go so far as to specifically say that interest should be awarded at the nondefault or at default contract rate.

In *Dow II*, the court thoroughly examined the legislative intent.[140] In that case, the court noted that Congress had clearly failed to specify whether interest should be awarded at the contract rate.[141] The court went on to say that if Congress had deliberately failed to specify the appropriate rate of interest, it would "suggest that the drafters chose to take the middle ground—neither categorically requiring nor prohibiting recognition of contract interest rates."[142] The *Dow II* court recognized that it was not entirely clear from the legislative history whether Congress intended for interest to be awarded at the nondefault or the default contract rate in order to make the plan fair and equitable. Given this absence of clear legislative intent, it remains uncertain how broad Congress intended the range of rates to be, within which judges would have the discretion to award postpetition interest.

Thus, an examination of the legislative intent with respect to the three areas of uncertainty under the current statutory regime reveals that Congress most likely did not specifically intend to create those uncertainties. Rather, it is likely that Congress intended for the legal rate to be given a single meaning by all courts. There is no clear indication from the legislative history that Congress specifically contemplated, much less intended to create, the uncertainty surrounding whether postpetition interest should be paid in the case of a reorganization solvent but liquidation insolvent debtor. It is also uncertain whether Congress intended to give judges such a broad range of rates from which to award postpetition interest under the fair and equitable standard of § 1129(b).

B. The Desirability of the Resulting Areas of Uncertainty and the Potential for Inconsistent Outcomes

If Congress did not specifically intend to create the uncertainty surrounding the award of postpetition interest to solvent debtors and the inconsistent outcomes that have resulted, the next necessary inquiry is whether this uncertainty and potential for inconsistent results is nevertheless a good thing. Furthermore, if they do not serve an important

140. *See Dow II*, 244 B.R. 678, 690–92 (Bankr. E.D. Mich. 1999).
141. *See id.* at 691.
142. *Id.*

purpose, then one must ask whether Congress should take action in order to clarify when postpetition interest should be awarded and at what rate.

It is hard to imagine any reasons why having different interpretations of the legal rate from court to court is a good thing. Generally, courts dislike when a provision of the Code is interpreted differently by different courts.[143] The practice offends general principles of statutory interpretation.[144] In addition, ambiguous language like "legal rate" is a source of unnecessary litigation whenever the issue arises.[145] It seems clear, therefore, that the courts' conflicting interpretations of the provision does not serve any legitimate purpose and Congress should clarify what it meant when it decided to award interest at the legal rate.

Similarly, it is hard to imagine any good reasons why the uncertainty with respect to whether postpetition interest is required in the case of a reorganization solvent but liquidation insolvent debtor is desirable. Since it is most likely that Congress did not even consider the possibility that a reorganization solvent but liquidation insolvent debtor would not have to pay postpetition interest, if brought to Congress's attention, Congress probably would take the opportunity to clarify its intentions on the matter. If the lack of clarity is allowed to persist, then courts may follow the approach used by the *Coram Healthcare* court and use the fair and equitable provision of § 1129(b) to allow or disallow postpetition interest at

143. *See* 73 AM. JUR. 2D *Statutes* § 175 (2001) ("Where the language of a statute is ambiguous, the courts will strive to avoid an interpretation producing a senseless distinction or discrimination, or the unequal operation generally, of the statute." (internal footnotes omitted)). One of the original reasons the overhaul of the bankruptcy laws in 1978 was the fact that, under the old Bankruptcy Act, there was a lack of uniform standards among the courts that resulted in the "unequal treatment of creditors and debtors." H.R. DOC. NO. 93-137, at 4 (1973). A Rand Corporation study also found that there was a "considerable variation in the treatment of like cases of debtors between jurisdictions." D.J. DREYFUSS, P.W. GREENWOOD, & M.R. FIORELLO, THE IMPACT OF PROPOSED CHANGES IN BANKRUPTCY ADMINISTRATION (1973), *reprinted in* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PART III, H.R. Doc. No. 93-137, at § 5, at v. (1973).

144. *See* 73 AM. JUR. 2D *Statutes* § 178 ("In the interpretation of statutes, a court should be astute in avoiding a construction which may be productive of much litigation and insecurity, or which would throw the meaning or administration of the law . . . into hopeless confusion or uncertainty." (internal footnotes omitted)).

145. *See* Joseph Pomykala, *Bankruptcy Reform: Principles and Guidelines*, REG.: THE CATO REV. OF BUS. & GOV'T, Nov. 4, 1997, at 7, *available at* http://www.cato.org/pubs/regulation/reg20n4e.html ("[U]ndefined legal terms such as 'fair rent' and 'interest at the legal rate' . . . foster subjective interpretation by judges and wasteful litigation."). Indeed, one of the main reasons for enacting the Bankruptcy Code in the first place was the fact that the old Bankruptcy Act had become incredibly inefficient. In the House Report establishing the Bankruptcy Study Commission, Congress made clear that the goal was to "revis[e] . . . the present system [so] that our bankruptcy laws can be brought up to date and be administered with a minimum cost both to the Government and to litigants." H.R. REP. NO. 91-927 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 3559, 3560.

the judge's discretion.[146] This would create the same problems of unpredictability and potential for inconsistent outcomes involved with the broad discretion given to judges under § 1129(b) generally.[147]

With respect to the question of whether it is desirable to give judges the discretion to award a broad range of interest rates, the argument could be made that some ambiguity or lack of clarity in the Code is desirable because it gives parties room to negotiate and reach a decision on their own. The reasoning is that if parties do not know exactly what they stand to receive in a cramdown, then they would have an incentive to bargain and to reach a compromise. The broad discretion given to judges, therefore, could have the effect of promoting out-of-court settlement between parties instead of a contentious court battle because neither party could predict the outcome in court.[148]

Interestingly, this argument in favor of a broad range of possible rates applies with even more force to the argument in favor of a clearly defined interest rate. The argument in favor of a broad range of interest rates is that parties will have an incentive to reach an agreement about the rate of postpetition interest because they are uncertain about what the judge will award. On the other hand, if the rate of postpetition interest is clearly defined by statute, it would be even easier for parties to agree on the appropriate rate of interest because there would be no debatable issue. If the interest rate is clearly defined, then the parties would not waste time reaching a middle ground on the issue. Instead, parties could focus on more important issues and avoid the transaction costs of reaching an agreement on the appropriate rate for postpetition interest.

Furthermore, while the argument in favor of a broad range of rates for postpetition interest may retain some persuasive force, it is unlikely that the marginal benefit that the broad range of rates confers on the overall process of confirming a plan outweighs the costs of such uncertainty. There comes a point at which, even though the discretion given to judges serves some purpose, the benefit is outweighed by competing costs. One such cost created by the current broad range of rates is unnecessary and wasteful

146. *See In re* Coram Healthcare Corp., 315 B.R. 321, 346 (Bankr. D. Del. 2004).

147. *See supra* Part III.C.

148. In the context of valuation, which can be even more uncertain than the appropriate rate of postpetition interest, one scholar has noted that since there are so many possible ways to value a debtor, "[d]etermining . . . the proper method of valuation to be used in any given context may be extremely difficult and give rise to protracted litigation." Pachulski, *supra* note 86, at 965. The author asserts, however, that "[t]he resulting uncertainty over the value that will be ascribed . . . by the court should spur the parties in interest to reach compromises that will avoid a battle over valuation." *Id.*

litigation.[149] When there are large sums of money on the line, and there is a broad range of rates at which interest could be awarded, it is inevitable that there will be a protracted legal battle over the appropriate rate.[150] It is nice to think that a court battle could be avoided because the ambiguity would encourage parties to reach an out-of-court agreement on the appropriate rate. That, however, is not always going to be the case. For one reason or another, parties might not be able to agree on the appropriate rate and they will resort to the courts to resolve the dispute. The dispute will undoubtedly deplete the estate's assets and reduce what each of the creditors could have otherwise recovered.

It should also be remembered that the class of cases being discussed are often surplus cases where little stands in the way of a successful reorganization other than the postpetition interest issue.[151] By definition, in surplus cases the unsecured creditors stand to receive the full value of their allowed claim.[152] Confirmation of the plan in such cases should be smooth and easy, but the lack of clarity with respect to the appropriate rate of postpetition interest could be the difference between a successful reorganization and an unsuccessful one. It seems self-evident that Congress should provide for a clear rate of interest so that the parties can promptly and easily confirm the plan.

Finally, another drawback to the broad range of rates is the uncertainty it creates in capital markets. It is well established that lenders need certainty in the bankruptcy laws.[153] When there is a lack of certainty, everybody suffers because "[d]efining the risks and making them predictable permits lenders to price loans and make financing available. Uncertainty, on the other hand, not only raises the cost of capital but also

149. *See* NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 259–63 (1997), *reprinted in* G COLLIER ON BANKRUPTCY, *supra* note 14, app. pt. 44-1, § 1.5.3. [hereinafter BANKRUPTCY: THE NEXT TWENTY YEARS] (noting that uncertainty around the appropriate interest rate causes unnecessary litigation); 7 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 1100.11[6][b] (noting that one of the weaknesses of § 77B under the former Bankruptcy Act was that it contained a plethora of ambiguities that led to unnecessary litigation); Pomykala, *supra* note 145, at 8.

150. The *Dow* cases are a good example of such a protracted legal dispute. *Dow I* was decided in 1999, and *Dow III* was not decided until seven years later in 2006. *See Dow I*, 237 B.R. 380 (Bankr. E.D. Mich. 1999); Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668 (6th Cir. 2006).

151. Again, the *Dow* cases are a good example of this. The only other issue holding up confirmation in *Dow III* was the issue of professionals' fees and expenses. *See In re Dow Corning Corp.*, 456 F.3d at 680.

152. *See* 11 U.S.C. §§ 726(a)(5), 1129(a)(7) (2000) (mandating that allowed claims be paid in full before postpetition interest is awarded).

153. *See, e.g.*, Craig H. Averch, *Bankruptcy Laws: What is Fair?*, LAW IN TRANSITION, Spring 2000, at 26, 31, *available at* http://www.ebrd.com/country/sector/law/insolve/about/fairlaw.pdf.

limits the availability of capital."[154] If lenders do not know how much they stand to receive in bankruptcy, the availability of credit will shrink and cost of capital to borrowers will increase.[155] This effect on the capital markets holds true even on an issue as rare as postpetition interest in the case of a solvent debtor. This is another reason why it may not be desirable to have such a broad range of rates at which postpetition interest can be awarded.

While the broad range of rates may provide some marginal benefit by encouraging the parties to reach an agreement on the appropriate rate, it is unlikely that this small benefit outweighs the costs of wasteful litigation,[156] of forestalling an otherwise smooth plan confirmation process, and of reducing available credit in the capital markets. To avoid these costs, Congress should speak clearly to the issue of at what rate postpetition should be awarded.[157]

V. PROPOSED AMENDMENTS TO THE CODE

In order to remedy the uncertainty and potential for inconsistent outcomes that the current statutory regime has created, Congress should make three minor amendments to the Code. First, Congress should clearly define the legal rate in § 726(a)(5) of the Code as the federal judgment rate. Second, Congress should amend § 1129(b) to specify that in order for a plan to be fair and equitable when a Chapter 11 debtor is solvent, the plan must provide for postpetition interest at the federal judgment rate. Finally,

154. *Id.*

155. *See id.*

156. Limiting unnecessary litigation is a widely recognized reason to clarify provisions of the Code through statutory amendment. *See, e.g.*, BANKRUPTCY: THE NEXT TWENTY YEARS, *supra* note 149, at 259–63 (advocating amending the Code because the current uncertainty in the Code causes unnecessary litigation).

157. Indeed, Congress has amended the Code in the past when it was unsatisfied with how the then-existing statutory regime dealt with the issue of postpetition interest. In 1994, Congress responded to the court's decision in *In re* New Valley Corp., 168 B.R. 73 (Bankr. D.N.J. 1994), *superseded by statute*, Bankruptcy Reform Act of 1994 § 213(d), Pub. L. No. 103-394, 108 Stat. 4106, 4125–26, in which the court held that a class of unsecured claims was unimpaired, and thus not entitled to postpetition interest. *In re New Valley Corp.,* 168 B.R. at 79. Under the terms of § 1124(3) at the time, a debtor could leave a class unimpaired if it paid the unsecured creditors the full amount of their allowed claim in cash in the effective date of the plan. *Id.* Unimpaired creditors are not entitled to vote on a plan, and are therefore not able to invoke the fair and equitable provision applicable in a cramdown. *See* 11 U.S.C. § 1129(b)(1). The court read § 1124(3) literally and held that the class was unimpaired and therefore not entitled to postpetition interest even though the debtor was liquidation and reorganization solvent. *In re New Valley Corp.*, 168 B.R. at 79. In order to "preclude this unfair result in the future" Congress deleted § 1124(3) from the Code. 140 CONG. REC. H10,768 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks). Since Congress was able to make the change in 1994, it seems fair to expect that they could do so again today in order to avoid further unfair results.

Congress should specify that in making the determination of whether a Chapter 11 debtor is solvent for the purposes of determining whether postpetition interest should be awarded under the fair and equitable provision of § 1129(b), courts should compare the debtor's reorganization value with the debtor's liabilities.

If Congress made these amendments to the Code, every one of the areas of uncertainty previously identified would be eliminated and the potential for inconsistent outcomes could be avoided. If the legal rate was clearly defined as the federal judgment rate, the appropriate rate of interest would be clear and courts would no longer have the ability to interpret § 726(a)(5) in inconsistent ways. If § 1129(b) was amended to specify that postpetition interest should be awarded at the federal judgment rate when a debtor is solvent in order to make the plan fair and equitable, judges would no longer have discretion to award interest within a broad range of rates. Finally, there would be no uncertainty with respect to whether a reorganization solvent but liquidation insolvent debtor is entitled to postpetition interest because the determination of solvency for the purposes of determining whether postpetition interest should be awarded under the fair and equitable requirement of § 1129(b) would be made by looking at the debtor's reorganization value. Thus, if the debtor was reorganization solvent but liquidation insolvent, creditors would be entitled to postpetition interest in a cramdown at the federal judgment rate just like every other creditor of a liquidation solvent Chapter 11 debtor. These proposed amendments do, however, raise several questions.

A. QUESTION ONE

Why should the legal rate of § 726(a)(5) be defined as the federal judgment rate instead of the contract rate? As already mentioned, there is significant debate over this very question.[158] The importance of the decision to define the legal rate as the federal judgment rate or as the contract rate is significantly diminished, however, once one realizes that neither approach is necessarily "creditor friendly" or "debtor friendly." Granted, we currently live in a relatively low interest rate environment where the federal judgment rate as established by the return on U.S. Treasury bonds typically is lower than most rates of interest in contracts between private parties.[159] However, this has not always been the case, nor

158. *See supra* Part III.A.

159. *See* Selected Interest Rates, *supra* note 119 (releasing selected interest rates weekly).

will it necessarily be so in the future.[160] It is easy to imagine a scenario in which a creditor and debtor entered into a long-term contract in a low interest rate environment with a relatively low fixed rate of interest. It is possible to imagine the federal judgment rate rising consistently over time, such that when the debtor files for bankruptcy some time thereafter, the federal judgment rate of interest is significantly higher than the rate in the contract. In such a scenario, if the debtor is a solvent entity, the shoe would be on the other foot and the debtor would argue that the court should apply the contract rate of interest instead of the federal judgment rate. Given this plausible hypothetical, it is evident that there is no clear "prodebtor" or "procreditor" petition in the debate over whether the legal rate of § 726(a)(5) should be defined as the contract rate or the federal judgment rate. With this in mind, the importance of Congress's decision of what rate to reference when defining the legal rate is significantly diminished. The need simply to choose one approach or the other so as to eliminate the uncertainty surrounding the issue is paramount.

Despite the aforementioned diminished importance of the decision, given that Congress must choose one approach or the other, Congress should define the legal rate of § 726(a)(5) as the federal judgment rate. The arguments on both sides of the issue are persuasive, but on balance, the arguments for defining the legal rate as the federal judgment rate are more convincing.

Courts following the state law approach use various lines of reasoning to reach their conclusion that the legal rate should be defined as the rate of interest in a contract between the debtor and creditors or at a rate of interest fixed by state statute. Some of these courts rely on pre-Code practice, where the award of postpetition interest in the case of a solvent debtor was left entirely up to a balancing of the equities of the case.[161] This approach was established by the pre-Code case *Vanston Bondholders Protective Committee v. Green*,[162] in which the Supreme Court said that "the touchstone of each decision on allowance of interest in bankruptcy . . . has been a balance of the equities between creditor and creditor or between

160. *See id.* (providing links to Federal Reserve historical data showing that in 1981 the rate on a one-year constant-maturity treasury bond was as high as 14 percent).

161. *See, e.g., In re* Fast, 318 B.R. 183, 192 (Bankr. D. Colo. 2004) (adopting a balancing-of-the-equities approach); *In re* Shaffer Furniture Co., 68 B.R. 827, 830 (Bankr. E.D. Pa. 1987), *abrogated by In re* Chiapetta, 159 B.R 152, 160 (Bankr. E.D. Pa. 1993) (noting that the award of postpetition is dependent on the "equities of the case").

162. Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 165 (1946), *superseded by statute*, Bankruptcy Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2549.

creditors and the debtor."[163] Some courts applying postpetition interest under the state law approach balance the equities and then, based on the particular facts of the case, determine that postpetition interest should be paid under § 726(a)(5) at the contract rate.[164] It has been widely recognized, however, that *Vanston*'s balancing-of-the-equities approach no longer is controlling because the creation of the Code superseded pre-Code practice and now expressly requires interest to be paid at the legal rate or in the absence of a contract, at the state statutory rate.[165] Thus, most courts have concluded that the award of postpetition interest under § 726(a)(5) is no longer discretionary and that the *Vanston* approach has been abrogated by statute.[166]

Other courts using the state law approach have relied on questionable authority for their determination that the legal rate is the contract rate. In *In re Carter*, the court cited mostly to cases[167] decided under § 506(b) for its conclusion that "[t]he majority of cases follow the state law approach by providing that when a creditor seeks interest on his or her claim, the bankruptcy courts apply the security agreement's interest rate."[168] Although the cases on which the court relied applied interest at the contract rate, those cases were decided under § 506(b), which only applies to postpetition interest in the case of an oversecured creditor, not a solvent debtor.[169] Thus, the *Carter* decision and others using similar reasoning are unpersuasive.

Still other courts using the state law approach have relied on the theory that an unsecured creditor should be restored to its prebankruptcy position if the debtor is solvent.[170] These courts accept the general assumption that if a debtor can afford to pay its contractual obligations, it should be required to do so.[171] While this reasoning is attractive for its simplicity, it is not firmly grounded in the text of the Bankruptcy Code.

Decisions holding that the legal rate of § 726(a)(5) should be defined

163. *Id.*

164. *See, e.g.*, *In re Fast*, 318 B.R. at 192; *In re Shaffer Furniture Co.*, 68 B.R. at 831.

165. *See In re* Manchester Gas Storage, Inc., 309 B.R. 354, 385 (Bankr. N.D. Okla. 2004); *Dow I*, 237 B.R. 380, 395 (Bankr. E.D. Mich. 1999); Lonstein & Domanowski, *supra* note 63, at 439.

166. *See, e.g.*, *In re Manchester*, 309 B.R. at 385; *Dow I*, 237 B.R. at 395.

167. *In re* Carter, 220 B.R. 411, 415 n.10 (Bankr. D. N.M. 1998).

168. *Id.* at 415.

169. *See* 11 U.S.C. § 506(b) (2000).

170. *See In re* Beck, 128 B.R. 571, 573 (Bankr. E.D. Okla. 1991) (defining the legal rate as the rate of interest that would have applied absent the petition being filed); *In re* Cont'l Airlines Corp., 110 B.R. 276, 280 (Bankr. S.D. Tex. 1989).

171. *See In re Beck*, 128 B.R. at 573.

as the federal judgment rate are much more convincing. The current trend clearly is to define the legal rate as the federal judgment rate.[172] *Cardelucci* is the only case decided by a federal appeals court to explicitly address the issue, and there the Ninth Circuit held that the legal rate should be defined as the federal judgment rate.[173] The court gave four reasons for its decision. First, the court said that principles of statutory interpretation strongly support defining the legal rate as the federal judgment rate.[174] Since Congress used the definite article "the," instead of the indefinite "a" or "an," Congress most likely intended for a single source to be used.[175] Second, the court held that using the federal judgment rate promotes uniformity within federal law.[176] Since a claim against the estate is analogous to postjudgment interest, to which the federal judgment rate typically applies, it makes sense to award postpetition interest at the same rate.[177] Third, the court reasoned that applying a single, easily determined interest rate to all claims for postpetition interest ensures equitable treatment of creditors.[178] A uniform interest rate ensures that no single creditor receives a disproportionate share of the remaining assets at the other creditors' expense.[179] Finally, the court held that the federal judgment rate was the most efficient and practical means for allocating the estate's assets.[180] The need to calculate the appropriate rate of interest to potentially thousands of creditors would significantly bog down the bankruptcy courts.[181] These four reasons led the court to conclude that the legal rate should be defined as the federal judgment rate.[182] Other courts have followed *Cardelucci*, and it is currently the leading case in the trend toward using the federal judgment rate.[183]

172. *See* Lonstein & Domanowski, *supra* note 63, at 425.

173. Onink v. Cardelucci (*In re* Cardelucci), 285 F.3d 1231, 1233 (9th Cir. 2002).

174. *Id.* at 1234.

175. *Id.* at 1234–35.

176. *Id.* at 1235.

177. *Id.*

178. *Id.*

179. *Id.* at 1236.

180. *Id.*

181. *Id.*

182. *Id.* at 1233.

183. *See In re* Wallace, No. 04–08560, 2007 Bankr. LEXIS 412, at *19–20 (Bankr. E.D. Wash. Jan. 29, 2007); *In re* Sapp, No. 01-08736-FJO-11, 2003 Bankr. LEXIS 2174, at *15 (Bankr. S.D. Ind. Mar. 4, 2003). A somewhat more novel argument for the proposition that the legal rate should be defined as the federal judgment rate was made by the court in the *Dow I* decision. *Dow I*, 237 B.R. 380, 395 (Bankr. E.D. Mich. 1999). In *Dow I*, the court took note of a law review article written by Chaim T. Fortgang and Lawrence P. King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148 (1981). *Dow I*, 237 B.R. at 395. In that article, the authors argued that Congress's decision to award postpetition interest at the legal rate was undesirable because they thought it would

Additionally, defining the legal rate as the federal judgment rate would create less potential for litigation than the state law approach. If Congress were to adopt the state law approach, courts would have to determine whether there was a valid contract between the parties and, if so, what the applicable rate of interest was in the contract. It is easy to imagine this inquiry resulting in a contentious dispute between the parties, especially when there are several potentially applicable contracts. The federal judgment rate approach, on the other hand, avoids this potential dispute by establishing the legal rate as an easily determined rate of interest.

In sum, defining the legal rate as the federal judgment rate is preferable to the state law approach. The reasons offered by the court in *Cardelucci* are more convincing and better reasoned than the reasons offered by courts that have defined the legal rate as the contract rate. Given that Congress should make a decision on the issue simply to resolve the existing uncertainty, the overwhelming weight of authority supports the conclusion that Congress should define the legal rate as the federal judgment rate.

B. QUESTION TWO

A second question regarding the proposed amendments is, why should postpetition interest be awarded under the fair and equitable provision of § 1129(b)? As already discussed, there is significant controversy surrounding courts' decisions to award postpetition interest pursuant to § 1129(b)'s fair and equitable mandate.[184] One reason why postpetition interest should be required at some rate under the fair and equitable provision of § 1129(b), however, is to be consistent with the legislative history. As noted earlier, although Congress did not specify what rate should apply, the legislative history clearly states that postpetition interest should be awarded for a plan to be fair and equitable when the debtor is

violate creditors' contractual rights. Fortgang & King, *supra*, at 1153. The court observed that the article's authors had recommended that Congress amend the Code to eliminate the words "at the legal rate" in order to reinstate the pre-Code practice of paying postpetition interest at the contract rate. *Dow I*, 237 B.R. at 395; Fortgang & King, *supra*, at 1161–64. As the *Dow I* court pointed out, the authors clearly thought that the enactment of § 726(a)(5) would significantly change the pre-Code practice of awarding postpetition interest at the contract rate. *Dow I*, 237 B.R. 380 at 395–96. The court also identified the interesting fact that one of the authors of the article was an editor of *Collier on Bankruptcy* and a consultant to the Commission on the Bankruptcy Laws of the United States, which played a large role in creating the Code in 1978. *Id.*

184. *See supra* note 63.

solvent.[185] The Sixth and Ninth Circuits have found this legislative history convincing and have already ruled that postpetition interest is appropriate pursuant to § 1129(b) when a debtor is solvent.[186] Furthermore, requiring postpetition interest under the fair and equitable standard would provide a way to resolve the uncertainty surrounding whether postpetition interest is required in the case of a reorganization solvent but liquidation insolvent debtor. If § 1129(b) was amended to require postpetition interest, the decision whether to award postpetition interest in the case of a reorganization solvent but liquidation insolvent debtor would no longer be left to the discretion of the bankruptcy judge based on an open ended determination of what is fair and equitable.[187]

C. QUESTION THREE

Given that postpetition interest should be awarded under § 1129(b), why should § 1129(b) be amended so that interest can only be awarded at a single rate? Might it be a good idea to allow judges discretion to award postpetition interest within a narrower range of rates? Although limiting the potential rates to a narrower range would limit to some extent the unpredictability of the possible outcomes, it would not eliminate the amount of unnecessary litigation around the issue as it would if the rate were defined as one single rate. Even with a relatively narrow range of possible rates, if there was enough money on the line, parties would still dispute the appropriate rate of interest. This could have the effect of holding up the confirmation of an otherwise successful reorganization. Confirmation would not be delayed, however, if the rate were established as one clearly defined rate. Thus, in order to eliminate excessive litigation over the issue of postpetition interest so that the debtor can confirm a plan promptly and emerge from Chapter 11, it is preferable to amend § 1129(b) to provide for interest at a single rate.

D. QUESTION FOUR

Given that interest should be awarded at one single rate under

185. *See* 140 CONG. REC. H10,768 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks). Even though the statement of legislative intent was made in 1994, not in 1978 when the Code was originally passed, the statement stands as the only indication on the record of Congress's intent on the issue.

186. Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d 668, 679–80 (6th Cir. 2006); Liberty Nat'l Enters. v. Ambanc La Mesa Ltd. P'ship (*In re* Ambanc La Mesa Ltd. P'ship), 115 F.3d 650, 654 (9th Cir. 1997).

187. *See infra* Part V.E (discussing why postpetition interest should be required in the case of a reorganization solvent but liquidation insolvent debtor).

§ 1129(b), why should it be awarded at the federal judgment rate? Opponents of this proposed amendment might argue that the rate of interest awarded under the fair and equitable provision of § 1129(b) should be higher than the federal judgment rate so that the parties will have room to negotiate for an intermediate rate. They might also point to the fact that some of the arguments offered for interpreting the legal rate as the federal judgment rate do not apply when considering at what rate interest should be awarded under the fair and equitable standard of § 1129(b). For instance, the argument based on statutory interpretation clearly does not apply because postpetition interest is not mentioned in § 1129(b).[188]

While these points are valid, there are several reasons why postpetition interest under § 1129(b) should be awarded at the federal judgment rate instead of at the contract rate. One reason given in *Cardelucci* that applies equally as well to the question of what rate should be used for postpetition interest under the fair and equitable standard of § 1129(b) is that using one standard rate of interest ensures equality of treatment among creditors of the same priority.[189] If one rate of interest is used, then it will be impossible for some creditors in a class of similarly situated creditors to receive a disproportionate share of the debtor's remaining assets. Consider the following situation.

Imagine a Chapter 11 debtor whose reorganization value is $210 million and whose liabilities total $200 million. Creditor A, a commercial lender, has a contract with the debtor that provides for a nondefault rate of interest at 10 percent. Creditor B, a personal injury tort claimant, does not have a contract with the debtor and, in the absence of a defined contract rate of interest, the court awards postpetition interest at the federal judgment rate of 5 percent. Both Creditor A and Creditor B have allowed claims of $100 million. As a result of their differing rates of interest, over the one-year pendency of the bankruptcy, Creditor A has accrued $10 million in postpetition interest and Creditor B has accrued $5 million. However, there is only a surplus of $10 million. A typical pro rata distribution in this case would result in Creditor A receiving $6.6 million of its postpetition interest claim and Creditor B receiving $3.3 million. Thus, even though Creditor A and Creditor B were both general unsecured creditors with underlying claims for the same amount of money, Creditor A

188. *See* Onink v. Cardelucci (*In re* Cardelucci), 285 F.3d 1231, 1234 (9th Cir. 2002). The argument based on the legislative intent that the *Dow I* court drew from the Fortgang & King article also does not apply because the authors of that article were referring exclusively to § 726(a)(5). *See Dow I*, 237 B.R. 380, 395–96 (Bankr. E.D. Mich. 1999).

189. *See In re Cardelucci*, 285 F.3d at 1235–36.

would receive twice as much in postpetition interest as Creditor B simply because Creditor A had the opportunity to enter into a contract with the debtor. This hypothetical illustrates how the use of the contract rate for postpetition interest could result in one creditor receiving a disproportionate share of the debtor's assets at the expense of other creditors with equal priority.[190] Such a result would not occur if a single rate of interest were employed.[191]

Furthermore, consider the administrative difficulties the court would face if postpetition interest was awarded at the contract rate under the fair and equitable requirement of § 1129(b). The court would initially have to determine whether valid contracts existed between the debtor and potentially thousands of parties. The court would also have to determine what the applicable rates of interest should be. Then, the court would have to determine accrued interest on each of the creditors' claims during the pendency of the case and what their pro rata shares of the surplus would be. Just as with the definition of the legal rate as the federal judgment rate, it makes sense simply to define the rate of interest as one single rate so that all of these administrative difficulties can be avoided. It should also be remembered that one purpose of adding § 502(b), which effectively banned postpetition interest, was to further the purposes of administrative convenience.[192] Clearly then, administrative convenience should be considered when determining the appropriate rate of postpetition interest. In fact, administrative convenience may be more important in some respects than making sure that creditors retain their prepetition contractual

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190. Similar reasoning is used to explain why unmatured interest is not included in the allowed amount of the claim as of the petition date:

> The reason for disallowing postpetition interest lies in the collective nature of bankruptcy. To understand it, consider that in the vast majority of bankruptcy cases, estate assets will be sufficient to pay only a portion of the claims. As of the moment of the filing of the petition, each unsecured creditor is entitled to a pro rata share of a fixed pool of assets. . . . If unsecured creditors were allowed to accrue interest on their claims at the rates specified in their contracts, the only effect would be to shift some of the recovery from low interest creditors to high interest creditors. While some might argue that is the bargain initially struck among the creditors, that is not the policy reflected in the Bankruptcy Code. Instead, for the purposes of accruing postpetition interest, all the unsecured creditors are equal, even if their initial contracts were different.

LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 114–15 (5th ed. 2006).

191. If the pool of available surplus is large enough to pay all claims for postpetition interest in full, then the equality of treatment of creditors with claims of equal priority would not be an issue. However, since it is unlikely that there will ever be a surplus of any amount, it is even less likely that the surplus will be sufficient to pay all the unsecured creditors the total amount of the postpetition interest that has accrued over the pendency of an often lengthy reorganization.

192. *See supra* note 15 and accompanying text.

rights.[193]

E. QUESTION FIVE

Another question the proposed amendments might raise is why should an unsecured creditor of a reorganization solvent but liquidation insolvent debtor be entitled to postpetition interest under the fair and equitable provision of § 1129(b)? It should be noted initially that under the proposed amendment, an unsecured creditor of a reorganization solvent but liquidation insolvent debtor still would not be entitled to postpetition interest under the best-interest-of-creditors test; it would only be entitled to postpetition interest if it belonged to a class that voted to reject the plan. This is accomplished by amending § 1129(b) so that postpetition interest is required in the case of a solvent debtor under the fair and equitable standard and by defining the determination of solvency by looking to the reorganization value of the debtor compared to its liabilities. The purpose of this structure is to allow the creditors to bargain away postpetition interest to the same extent that they can bargain away principal. The absolute priority rule and its fair and equitable requirement kicks in only if a class votes to reject the plan, thus requiring postpetition interest to be paid at the federal judgment rate. Therefore, unsecured creditors of a reorganization solvent but liquidation insolvent debtor could decide as a class whether they want to push for postpetition interest in a cramdown, or whether they are satisfied with what the debtor has offered them under the plan.[194]

The main point of this structure is to ensure that the creditors of a reorganization solvent but liquidation insolvent debtor have rights that are similar to the creditors of a debtor that is solvent on both a liquidation and reorganization basis. In both cases, the debtor is emerging as a reorganized

193. *See In re Cardelucci*, 285 F.3d at 1236 (noting that "application of the federal rate is the most judicially efficient and practical manner of allocating remaining assets"); *supra* note 15 and accompanying text.

194. Because of the inherent uncertainty in valuing the debtor, a class of creditors might be willing to accept the amount of postpetition interest provided for under the plan, rather than to gamble and see what the court determines to be the debtor's going-concern value. The interplay between the best-interest-of-creditors test laid out in § 1129(a)(7) and the absolute priority rule codified in § 1129(b) reflects the tension between whether creditors are entitled to be compensated for their claims based on the debtor's liquidation value or its going-concern value. Pachulski, *supra* note 86, at 952. Some have framed the issue as, who is entitled to the "going-concern bonus" of a reorganized debtor—the creditors or shareholders? *Id.* The going-concern bonus is understood as the amount by which the going-concern value of income-producing assets exceeds their liquidation value. *Id.* at 952 n.117. In a cramdown, the dissenting creditors can be bound if the requisite majority determines that the plan gives them a fair deal based on their own determination of the debtor's reorganization value. *See* 11 U.S.C. § 1126(c) (2000).

entity, not liquidating, and therefore it would be fair to require both classes of unsecured creditors to receive similar amounts of postpetition interest.[195] At the same time, however, the proposed amendment respects the recognized policy that the absolute priority rule does not kick in unless a class votes to reject the plan, thereby allowing the creditors to bargain away as much of the postpetition interest that the class deems appropriate.

In essence, what this amendment does is adopt the reasoning of the *Coram Healthcare* decision.[196] In that case, the court said that the reorganization value was the appropriate value to look at in order to determine whether the debtor was solvent and, therefore, should pay postpetition interest.[197] This amendment takes the same approach and says that in the case of a reorganization solvent but liquidation insolvent debtor, the going-concern value is the relevant value for determining whether the debtor should have to pay postpetition interest under the fair and equitable provision of § 1129(b). Given that § 1129(b) would also be amended to expressly provide for postpetition interest in the case of a solvent debtor, the infirmities of simply relying on the *Coram Healthcare* approach would be avoided. For one thing, the precedential value of the *Dow II* and *III* cases would no longer be questionable because the Code would be expressly amended to state that postpetition interest is part of the fair and equitable requirement. Furthermore, the possibility for a wide range of rates under the fair and equitable standard would not exist because the Code would be amended to specify the rate as the federal judgment rate. Thus, the *Coram Healthcare* approach would be adopted, with the added benefit that there would be no uncertainty as to whether, and at what rate, postpetition interest must be awarded in future cases of reorganization solvent but liquidation insolvent debtors.

VI. CONCLUSION

The current statutory regime providing for postpetition interest in the case of a solvent debtor has created areas of uncertainty as to when, and at what rate, postpetition interest is required, thus fostering inconsistent and unpredictable outcomes. Although solvent-debtor cases are not extremely common, when they do occur there can be massive sums of money in dispute based on the issue of whether, and at what rate, postpetition interest

195. *See* Pachulski, *supra* note 86, at 960 (noting that under the old Bankruptcy Act, a majority of courts valued income-producing collateral on a going-concern basis justified by that fact that “the entire theory of a reorganization proceeding is that a reorganization of a going business is taking place”).

196. *In re* Coram Healthcare Corp., 315 B.R. 321, 345 (Bankr. D. Del. 2004).

197. *See id.*

should be awarded. As the preceding discussion has established, there are three areas of uncertainty: (1) the ambiguous wording of the legal rate in § 726(a)(5) has created conflicting decisions regarding its definition; (2) it is unclear whether postpetition interest should be awarded in the case of a reorganization solvent but liquidation insolvent debtor; and (3) the discretion given to judges to choose the rate of postpetition interest within such a broad range of rates creates the potential for inconsistent and unpredictable outcomes. These areas of uncertainty and the resulting inconsistent outcomes probably were not specifically intended by Congress, nor do they further an important purpose of the Code.

Therefore, Congress should make three minor amendments to the Code. First, Congress should define the legal rate as the federal judgment rate. Second, Congress should explicitly state that postpetition interest is required at the federal judgment rate when a debtor is solvent under § 1129(b) to make the plan fair and equitable. Third, Congress should require postpetition interest at the federal judgment rate in the case of a reorganization solvent but liquidation insolvent debtor under the fair and equitable standard by making it clear that the relevant value for determining a debtor's solvency in a cramdown is its reorganization value. These amendments would resolve the existing uncertainty and potential for inconsistent and unpredictable outcomes by clearly defining when and at what rate postpetition interest is required.

Although there may be disputes over the specifics of some of the proposed amendments, it should be remembered that neither of these proposed amendments are necessarily debtor friendly or creditor friendly because the federal judgment rate is a floating rate of interest that could potentially be higher than a given contract rate of interest. What is of paramount importance, however, is for Congress to come forward with a clear statement about when postpetition interest is required and what the required rate is. The existing uncertainty in each of these areas only causes wasteful litigation over the issue and forestalls the plan confirmation process. It also may have the negative effect of reducing the availability of credit and increasing its cost to consumers. Congress should clarify when postpetition interest is required and at what rate so as to avoid these negative consequences.