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Oversecured Creditors Under Bankruptcy Code Section 506(b): The Limits of Postpetition Interest, Attorneys' Fees, and Collection Expenses

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OVERSECURED CREDITORS UNDER BANKRUPTCY CODE SECTION 506(b): THE LIMITS OF POSTPETITION INTEREST, ATTORNEYS' FEES, AND COLLECTION EXPENSES

by
David Gray Carlson*

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* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. Thanks to Jeanne L. Schroeder and Paul M. Schupack for their perceptive comments on an earlier draft of this essay. This article will eventually become a chapter in G. GILMORE & D. CARLSON, SECURITY INTERESTS IN PERSONAL PROPERTY (2d ed.) (forthcoming).
Interest income—this subject may seem juiceless, but business persons know how vital a question it is. If interest is not paid to a lending institution, the loan has become an unproductive asset. Today's monumental savings and loan crisis is nothing but a failure of interest income. Any entrepreneur knows that failure to generate enough income to cover debt service means, at the very least, workout negotiations and a consequent loss of freedom to maneuver. At worst, it could mean failure of the business enterprise and the destruction of jobs, lives, and families.

The Supreme Court has understood the importance of interest income and has recently given us two major pronouncements on the subject in the context of bankruptcy.

A. Timbers of Inwood Forest

In the first of these opinions, United Savings Association of Texas v. Timbers of Inwood Forest, Ltd., Justice Scalia, writing for a unanimous court, ruled that an undersecured creditor could not have interest income after a bankruptcy petition. Undersecured creditors thought that they deserved interest income as part of their right to adequate protection of the value of their collateral, and a great many lower court opinions agreed.

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2 For example, a $100,000 claim, secured by a lien on collateral with a value of $80,000, is an undersecured claim. According to Bankruptcy Code § 506(a), quoted infra in text accompanying note 9, the creditor has a secured claim of $80,000 and an unsecured claim of $20,000, while the full claim is $100,000. See 3 COLLIER ON BANKRUPTCY ¶ 506.04, at 506-15 (15th ed. 1989).
3 484 U.S. at 372-73.
Justice Scalia, however, pointed out that oversecured creditors have an express statutory right to postpetition interest in Bankruptcy Code Section 506(b), which provides:

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

Justice Scalia reasoned that if oversecured creditors had an express right to postpetition interest, then, by implication, undersecured creditors had none.

In the course of so ruling, Scalia endorsed the view that the equity cushion constitutes the strict limit placed on an oversecured party to collect postpetition interest. This status of the cushion as a limit to postpetition interest is founded on Section 506(b)'s phrase "to the extent." That is, to the extent there is an equity cushion, the oversecured party can have postpetition interest. For any amount beyond that, the oversecured party becomes an undersecured party and can have nothing.

The equity cushion’s status as a limit to postpetition interest implies that if a bankruptcy proceeding lasts long enough, all oversecured parties
will eventually be undersecured parties. Timbers of Inwood Forest, then, constitutes a major pronouncement on the rights of oversecured creditors. Its establishment of the equity cushion as the limit of Section 506(b) rights, however, creates an unacknowledged contradiction for bankruptcy courts. The contradiction is this—a common method for satisfying the estate’s postpetition interest obligation to an oversecured creditor is to pay the secured creditor from time to time. If those payments are made to an oversecured creditor, then the equity cushion is enlarged or preserved. Yet this cushion is also the outward limit of postpetition entitlements. These postpetition payments threaten to violate Timbers of Inwood Forest if they result in the oversecured creditor receiving more interest income than the total, original equity cushion. This article will first address the contradiction between Section 506(b) (as read by the Supreme Court in Timbers of Inwood Forest) and cash payments of interest (or adequate protection payments under Section 361(1)).

This article will then explore a way that courts could reconcile this seeming contradiction. Specifically, during the pendency of the bankruptcy proceeding, courts should avoid paying oversecured creditors anything. Instead, if cash outflow to secured creditors is called for, trustees should buy part of the secured claim, not pay it. As a result, trustees will be able to exhaust the equity cushion with a combined aggregate of security interests belonging to the secured creditor and the bankrupt estate. This combined accrual of security interests will help ensure that the trustees and courts are following Justice Scalia’s suggestion that the equity cushion constitutes the limit of postpetition interest that oversecured creditors can receive.

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

Section 506(b) provides for only the allowance of postpetition interest for the oversecured creditor and does not require the payment of the interest. The power of the bankruptcy trustee to “pay” the interest currently arises from another source, such as adequate protection according to § 361. See 3 COLLIER ON BANKRUPTCY ¶ 506.5, at 506-43 (15th ed. 1989). Section 361 provides in pertinent part:

When adequate protection is required . . . of an interest of an entity in property, such adequate protection may be provided by—

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay, . . . use, sale or lease . . . or any grant of a lien . . . results in a decrease in the value of such entity’s interest in such property;

. . . .

(3) granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity’s interest in such property.

B. Ron Pair

The second Supreme Court opinion concerning oversecured creditors is *United States v. Ron Pair Enterprises, Inc.* In *Ron Pair*, the Internal Revenue Service (IRS) was oversecured by virtue of its tax lien and requested interest income under Section 506(b). Now recall that Section 506(b) holds that "to the extent" there is an equity cushion, "there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." Emphasizing the italicized words, the debtor-in-possession asserted that the right to postpetition interest must be provided by a contract; otherwise, no such right existed.

The Supreme Court, however, took the position that Section 506(b) required that only "fees, costs, or charges" must be memorialized in a contract. Interest, it reasoned, was unconnected to the contract, being separated from it by virtue of an all-important comma after the word "claim." According to the Court, the right to postpetition interest is noncontractual, while the right to "fees, costs, or charges" is grounded in contract.

Justice Blackmun explained the effect of this important comma:

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

In other words, the right to interest is unconnected to the contract. From this it follows that some noncontractual interest rate should be used, even if there is a contract rate. That is, the proper rate of interest is open to

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15 *Ron Pair*, 109 S. Ct. at 1028.
16 Id.
19 Id. at 1028-29.
20 Id.
21 Id. at 1031-32.
22 See Warehouse Home Furnishings Distrib., Inc. v. Gladdin (*In re* Gladdin), 107 Bankr. 803,
choice, even if the creditor and debtor are parties to a loan agreement. Ron Pair, then, establishes the noncontractual nature of postpetition interest. To this must be contrasted the purely contractual nature of "fees, costs, and charges." Some of these charges might include attorneys' fees for pursuing self-interested positions of secured creditors—all at the expense of the bankrupt estate. Others include prepayment premiums, default penalties, higher default penalties, and interest on interest. This article will explore the extent to which general creditors have to pay for such extravagances.

Here is how this article will proceed. First, as mentioned, the article will review the ways in which adequate protection payments to oversecured creditors can violate the premise of Timbers of Inwood Forest, which establishes the equity cushion as the outward limit of postpetition interest entitlements. This review will include a discussion of the extent to which a trustee can block postpetition interest entitlements by strategically removing the equity cushion before (or perhaps even after) postpetition interest has accrued.

Second, the article will examine the choice of an interest rate, now that Ron Pair has dethroned the contract rate as the necessary, required rate. Next, the article will analyze the extent to which a secured creditor can use the equity cushion to pay for various hostile activities, such as moving to lift the automatic stay or maximizing the secured creditor's po-

805-06 (Bankr. M.D. Ga. 1989) ("The plain language of section 506(b) does not require that interest be paid at the contract rate. It simply requires that interest be paid." Nevertheless, the court imposed the contract rate as a matter of prudence.).

Before Ron Pair, many courts assumed that the contract rate was mandatory under § 506(b). That is, they assumed that the oversecured party must receive the interest "provided for under the agreement." See, e.g., United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.), 793 F.2d 1380, 1407 (5th Cir. 1986), aff'd en banc, 808 F.2d 363 (1987), aff'd, 484 U.S. 365 (1988); Schlag v. Mendelson (In re Schlag), 60 Bankr. 749, 751 (Bankr. W.D. Pa. 1986).

88 See In re Laymon, 117 Bankr. 856, 858-59 (Bankr. W.D. Tex. 1990). Contra Warehouse Home Furnishings Dists., Inc. v. Gladdin (In re Gladdin), 107 Bankr. 803 (Bankr. M.D. Ga. 1989) (arguing that neither § 506(b) nor Ron Pair authorizes the overthrow of the contract rate). For a post-Pair argument to the contrary, see Cohen, Marwil & Gerard, Entitlements of Secured Creditors to Default Interest Rates Under Bankruptcy Code Sections 506(b) and 1124, 45 Bus. Law. 415 (1989). These commentators opine that Ron Pair established only the following:

The separation of the two operative phrases by the comma was necessary only to indicate that oversecured claim holders would be entitled to interest even in the absence of an agreement between the parties, particularly in tort and other non-contractual lien claims.

Id. at 417. The authors further assert that the Supreme Court has left "for another time the issue of allowability of [contractual] default interest rates," but they add that "[t]he analysis in Ron Pair . . . chills any argument that oversecured creditors are entitled to contract default rates of interest, as a matter of right under the literal terms of the statute." Id. at 424 n.38.
sition in bankruptcy. The use of the equity cushion for prepayment premiums, default penalties, and higher postdefault interest rates will also be analyzed. The final part will discuss whether the rule against interest on interest, set forth in *Vanston Bondholders Protective Committee v. Green,* still remains good law in light of *Ron Pair* and will conclude that it does, although the premises of *Vanston,* then as now, can be questioned.

II. THE EQUITY CUSHION AS THE LIMIT OF POSTPETITION INTEREST

As stated earlier, treating the equity cushion as the limit of postpetition interest contradicts the notion of payment as a means of adequate protection for depreciating collateral. The following schematic drawing will be useful in describing the contradiction.  

- *Adequately Large Equity Cushion and Accruing Interest*

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This illustration is based upon some preliminary work done in Carlson, *supra* note 10, at 636-50.
In Figure One, the left ordinate represents the face amount of dollars today. The right ordinate represents the face amount of dollars at the time the bankruptcy proceeding is expected to be concluded. The abscissa represents time. Assume for the moment that the oversecured party is not paid cash. Instead, interest is allowed to accrue against the shrinking debtor’s equity. Assume also that compound interest is not allowed in bankruptcy.36

In such a case, an oversecured party will never become undersecured. In Figure One, collateral value stays constant at $1,000. That is, collateral value travels in a horizontal line from point $A$ to point $E$. As interest accrues at the rate of 10 percent per year, the amount of the secured claim increases from $900 at the beginning of the bankruptcy proceeding27 to $990 at the time the proceeding ends.38 This is shown by the upward sloping line $BD$. As a result, debtor equity shrinks from $100 at the beginning of bankruptcy (line $AB$) to $10 at the end of the proceeding (line $DE$).

A. How Adequate Protection Payments Might Exceed the Equity Cushion

Figure Two illustrates how adequate protection payments might violate *Timbers of Inwood Forest* by awarding the secured creditor more than the equity cushion.

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36 This was the holding in Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 165 (1946). Whether this case is still good law will be discussed in the next section.

37 Represented by line $BX$.

38 Represented by line $DZ$ on the right ordinate. $DZ$ is broken into two parts. The secured claim representing postpetition interest is $CD$. The secured claim representing original principal is $CZ$. $BX = CZ = $900.
Inadequate Equity Cushion and Periodic Payment of Interest

In this case, the collateral depreciates in value from $1,000 to $790. This is shown by the declining slope of AE*. Meanwhile, postpetition interest is not allowed to accrue. Rather, the trustee periodically pays the oversecured party in cash. Over the course of the year, these payments equal $90. Therefore, the postpetition entitlements in both Figure One and Figure Two are precisely identical. 29

Because postpetition interest is paid out periodically instead of accrued against the collateral, the secured creditor can reinvest the $90 and earn a return, which is in effect the interest on interest that federal law apparently prohibits. See infra notes 229-245 and accompanying text. For example, assume an interest rate of 10%, so that the trustee pays interest of $7.50 per month at the end of each month. If the secured party invests this sum and obtains continually compounding 10% interest on the investment, the formula for the secured party's total return (V) is as follows:

\[ V = 900 + \sum_{t=1}^{12} 7.5e^x \]

where \( x = .1 \left[ 1 - \frac{t}{12} \right] \)
Notice that after point $Y$ in time, the equity cushion has depreciated below the amount of interest dollars actually paid out. After point $Y$, the now undersecured creditor receives postpetition interest beyond the amount of the equity cushion.\textsuperscript{30} Potentially, adequate protection schemes such as the one illustrated in Figure Two violate Timbers of Inwood Forest. Whether they do, however, depends on what property rules are presupposed with respect to equity cushions.

There are three such presuppositions. The first view holds that the secured party is entitled to adequate protection of the equity cushion as it existed at the start of the bankruptcy (AB). Therefore, payment of interest past time $Y$ is appropriate because the total eventually paid out (DC) is still less than the initial cushion (AB).\textsuperscript{81} This view of the equity cushion was taken in Hamilton Bank v. Diaconx Corp. (In re Diaconx Corp.).\textsuperscript{82}

Although some courts might become squeamish about awarding unaccrued interest, the preservation of the equity cushion would not constitute the award of any such thing. Rather, a court would be protecting the oversecured party’s rights under Section 506(b) to utilize the equity cushion for postpetition interest as it eventually accrues.\textsuperscript{83} Meanwhile, the

\[ \text{and where } t = \text{number of months it takes before the secured party receives the payment.} \]

According to this formula, the secured party’s rights in bankruptcy (given monthly payments of $7.50 for one year) are worth $994.259985.


\textsuperscript{81} The total paid out (DC) is less than the initial equity cushion (AB) by an amount of ED (AB - EC; EC - DC = ED).

\textsuperscript{82} 69 Bankr. 333 (Bankr. E.D. Pa. 1987). To be precise, it was not interest that was anticipated, but attorneys’ fees and collection expenses, the second branch of the secured creditor’s § 506(b) entitlements. Id. at 339. Nevertheless, the principle can be used analogously for postpetition interest as well. Id. at 339 n.9.

\textsuperscript{83} In potential support of this proposition is an argument made by Judge Hargrove:

When two parties contract, they are free to deal with one another as they please. Therefore, when a security interest is granted, the party granting the security interest is fully cognizant of both the value of the underlying obligation and the value of the security interest which is placed “at risk” in the event that party fails to pay. On the other side of this transaction, the party receiving the security interest is free to demand security of sufficient value to cover any anticipated exposure caused by the other party’s failure to perform on the underlying obligation. Section 506(b) merely respects the party’s contractual rights by allowing the secured party the full extent of his bargained for security. In re D.W.G.K. Restaurants, Inc., 84 Bankr. 684, 686 (Bankr. S.D. Cal. 1988). This argument, however, fails to see a key point. The contractual right of an oversecured creditor can, at best, be in the nature of a negative pledge covenant—itself an unsecured claim and not a property claim. Nothing
equity cushion as preserved at the time of the initial valuation will constitute the limit of postpetition interest that an undersecured party can receive, a principle fully consistent with *Timbers of Inwood Forest*.

The idea of preserving the equity cushion was rejected in at least one case under the old Bankruptcy Act. In *In re Apollo Travel, Inc.*, a secured creditor sought to preserve an equity cushion for attorneys' fees which had not yet accrued. In that case, Judge Gibson, looking to state law, held that the bankruptcy trustee had a senior claim to the secured party for the equity cushion. The cushion could not be preserved for the secured party's future benefit.

A problem with the view that preserves the equity cushion at the start of the bankruptcy proceeding "for interest or collection expenses not yet accrued" is that the trustee is being excluded from property of the bankrupt estate, on which the secured party does not yet have a claim. Accordingly, a second view of the equity cushion rejects the need to set aside debtor equity for postpetition interest that has not yet accrued. This view would also prohibit, at any given time, the invasion of the secured claim as it presently existed, as augmented by any postpetition interest or collection expenses that may have accrued. Thus, in Figure Two, even though the trustee can use the *entire* equity cushion at or near the time of the bankruptcy petition, this right shrinks over time until it disappears at time *Y*. After time *Y*, depreciation is invading the secured claim, so that the trustee must provide adequate protection for the now under-

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84 Using Figure One, the idea would be that the trustee must never interfere with the secured party's right to realize *DZ* on the day the Chapter 11 plan is confirmed. Therefore, the value of the collateral (and replacement collateral supplied by the trustee in light of depreciation) must never fall below the line *BD*. If so, the secured party is entitled to have the automatic stay lifted.


86 Republic Acceptance Corp. v. Salmen (*In re Apollo Travel, Inc.*), 567 F.2d 841 (8th Cir. 1977).

87 *Id.* at 842.

88 *Id.* at 844-47.

89 For example, the trustee might obtain a loan from a postpetition creditor in exchange for a super priority lien. See 11 U.S.C. § 364(d) (1988). The proceeds of the loan would enrich the general creditors, while the super priority lien would block any further accrual of postpetition interest.

90 The invasion right shrinks because the value of the property decreases due to depreciation (*AC*-) and the secured claim, increases because postpetition interest and collection expenses are accruing (*BC*).
secured creditor if she wishes to keep the automatic stay effective. The amount of adequate protection required in Figure Two will eventually reach $930 (YC*).

This view mediates between two potentially conflicting bankruptcy principles. The first principle holds that the debtor's equity is property of the estate. As such, it should be available for use by the estate, even if the use interferes with the future accrual of interest. The second principle is that secured parties are entitled to adequate protection for their secured claims. If the trustee may not invade the collateral needed to support accrued postpetition interest (without supplying adequate protection), then the policy of adequate protection is vindicated as well.

If this second view of the equity cushion is adopted, then the interest payments in Figure Two violate Timbers of Inwood Forest. In Figure

\[ V = 900 + \sum_{t=1}^{4} 7.5e^x \]

where \( x = 0.1 \left( 1 - \frac{t}{12} \right) \)

This amounts to $932.37295.

If adequate protection is accomplished through cash payments, 11 U.S.C. § 361(1) (1988), the secured party's claim is worth even more because now the secured party can earn continuously compounding interest on the adequate protection payments as well. Since the above assumptions reveal the collateral to be depreciating by $17.50 per month, and if we assume that in the fifth month the trustee stops interest payments of $7.50 per month and commences adequate protection payments of $17.50, the value of the secured claim is as follows:

\[ V = 900 - 140 + \sum_{t=1}^{4} 7.5e^x + \sum_{t=5}^{12} 17.5e^x \]

where \( x = 0.1 \left( 1 - \frac{t}{12} \right) \)

\[ V = 900 - 140 + 320.37295 + 144.16974 - 936.54269. \]

See In re Triplett, 87 Bankr. 25, 27 (Bankr. W.D. Texas 1988) (secured party had no right to complain that the debtor-in-possession was using the equity cushion).

\[ \text{See 11 U.S.C. § 363(e) (1988).} \]
Two, the secured party is oversecured between time X and Y and undersecured between times Y and Z. For courts wishing to establish the equity cushion as the limit of interest for the oversecured party, periodic interest can be paid only until time Y.

Instead of the accrual of postpetition interest, the bankruptcy trustee's concern now turns to adequate protection. If the bankruptcy trustee invades the secured claim, the secured party is entitled to have the automatic stay lifted unless the trustee supplies adequate protection against further depreciation. In Figure Two, this is accomplished by providing the secured creditor with additional collateral starting at time Y.\(^4\) Meanwhile, the effect on income of the total scheme is beneficial to the trustee. The trustee's expense of retaining the collateral is reduced because, after time Y, the trustee is relieved of the need to pay out interest.\(^4\)

So far, this article has presented two views on the law of Section 506(b). The first view favors the secured creditor because it required preserving for her enough equity cushion to cover postpetition interest that has not yet accrued. Under the second view, just presented, the set-aside of debtor equity was rejected. Instead, the trustee could use the equity for the benefit of the estate as long as she did not invade the secured claim as it existed at any given time. There is also a third view, which is more radically favorable to the debtor and prejudicial to secured parties. According to this third view, the trustee in bankruptcy may invade that part of the secured claim that represents postpetition interest or postpetition collection expenses. Only the secured claim at the start of bankruptcy (BX) is entitled to adequate protection. Even at time Z, the trustee can still use the full equity cushion (EC) for estate purposes.

According to this view, Section 506(b) means that the oversecured creditor gets postpetition interest only if, by the time of confirmation or sale of the collateral, the trustee has failed to expropriate or depreciate the equity cushion. That is, so long as the initial secured claim, representing prepetition claims, is protected, an oversecured party has no right to com-

\(^4\) This extra collateral is represented by CD*. The trustee could also pay the secured creditor CD*. This, however, is not illustrated in Figure Three. For a mathematical illustration of adequate protection payments and its effect on the value of secured claims, see supra note 42 and accompanying text.

\(^4\) This is so even if the trustee must pay adequate protection in cash. In supra note 42, while the cost of four months' postpetition interest was $32.37, the cost of eight months' adequate protection was only $4.17. This was so even though the monthly interest payment ($7.50) was far less than the monthly adequate protection payment ($17.50). The solution to this apparent paradox is that postpetition interest adds to the principal of $900, whereas adequate protection payments are deemed to be retirement of principal.
plain about a shrinking equity cushion. This anti-creditor view has been adopted by some courts.47

Surprisingly, the Bankruptcy Act of 1898 probably supported this view. Prior to 1978, there was no express statutory right to adequate protection. Instead, the secured party simply hoped that the value of the collateral did not deteriorate over time. Therefore, so long as the trustee still controlled the collateral, she had no adequate protection obligation at all to secured creditors for either the original secured claim or the claim for postpetition interest.48 On the other hand, courts often lifted the stay in bankruptcy if the secured party claimed the stay to be prejudicial.49 Such a request, however, was within the discretion of the court to deny.50 If the stay was lifted, then the secured party could obtain a form of postpetition interest by obtaining and reinvesting cash proceeds from a nonbankruptcy sale of the collateral.51 Therefore, prior to 1978, oversecured creditors did receive postpetition interest albeit through lifting the stay. It is not exactly the case that bankruptcy trustees could invade secured claims at will because such an invasion was grounds to lift the stay.

Even if the trustee could invade the secured claim, the current statute expressly requires adequate protection,53 thereby overruling any implicit rule to the contrary under the former Bankruptcy Act. The addition of a specific obligation of adequate protection, coupled with the Section 506(b) interest as part of the secured claim, should eliminate this third anti-creditor view of the equity cushion.

To summarize, Figure Two shows the problems caused when the trustee pays out postpetition interest. If the second, middle view of the equity cushion is adopted—under which the trustee may use the equity cushion but may not invade the accrued secured claim—then these payments violate Timbers of Inwood Forest. What is needed is a way for the trustee to stop postpetition interest after time $Y$.

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46 For a history of adequate protection before the 1898 Act, see Carlson, supra note 10, at 581-84.

49 Id. at 590-96.

50 Id.

51 Id.

B. Purchases in Lieu of Payments

This potentially tricky accounting problem can be solved by characterizing the payments of interest not as payments at all, but as purchases by the trustee of the secured party's secured claim for the amount of the postpetition interest in question. That is, the interest debt created by Section 506(b) would not be paid at all, in the sense of extinguishing antecedent debt, but would be sold. This idea would help the trustee determine when the entitlement cushion has disappeared and when further interest "payments" (that is, further purchases of the secured claim for interest) should cease. At this time (time $Y$, in Figure Two), the secured party would hold a secured claim for the principal amount of her debt, and the trustee would hold a security interest for any postpetition interest of the senior secured party. These two security interests would be pari passu with each other in that the trustee is buying a portion of the secured party's entire claim.

Buying the secured claim (to the extent of postpetition interest) when the collateral is depreciating in value is especially superior to simply paying it. For example, if payments are deemed to extinguish postpetition interest, represented in Figure Three as $BY$, interest does not accrue at all, and the equity cushion lasts longer. That is, $Y$ shifts over to become $Y^*$.  

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To be more precise, the secured party would hold a secured claim for the principal and any accrued prepetition interest.
The Effect on the Equity Cushion of Paying Interest Periodically

The suggestion being made here—pre-confirmation payments to oversecured parties should not be payments at all but purchases of secured debt—would prevent the over-accrual of interest and avoid a violation of *Timbers of Inwood Forest*. If the trustee owned a security interest for the amount of $CC^*$, it would then be clear that, at time $Y$, the equity cushion was exhausted, and hence no further postpetition interest entitlements could be given to the now undersecured party.\(^4\)

\(^4\) Under the solution proposed here, the secured claim was worth $932,372.95 (if adequate protection payments were made and collateral substituted). If the bankruptcy court allows time $Y$ to shift rightward and become time $Y^*$, then the secured claim is worth more. For example, if line $YY^*$ represents an additional month of postpetition interest, the secured claim increases in value to $940,323.46. An increased adequate protection obligation represented by line $CC^*$ would offset this increase in the value of the secured claim, but, as seen in *supra* note 42, the cost of postpetition interest payments far exceeds the cost of adequate protection payments where the equity cushion is of a comparable size. Of course, neither adequate protection nor postpetition interest need be paid in
III. WHAT INTEREST RATE SHOULD OVERSECURED CREDITORS RECEIVE?

A. Section 506(b)'s Indeterminacy

Postpetition interest entitlements under Section 506(b) are not the only situations requiring a choice of the proper interest rate for over­
secured creditors. A reorganization plan may require such a choice as well. A plan may provide secured parties with debt instruments (in lieu of cash or release of the collateral), which must have an appropriate discount rate. With regard to discount rates for reorganization plans, the point is to equate the present value of the debt instruments with the present value of the secured party's collateral. Given such a goal, the choice of an interest rate ought to be entirely technical. The only concern is that the debt instruments have a present value equal to the amount of the secured claim.

The interest rate contemplated by Section 506(b) does not necessarily concern preserving the present value of the secured claim, and therefore the choice of rates is not necessarily technical. Section 506(b) provides:

To the extent [there is an equity cushion,) there shall be allowed to the
holder of such claim, interest on such claim, and any reasonable fees, costs,
or charges provided for under the agreement under which such claim
arose.

As previously discussed, the Supreme Court in United States v. Ron
Pair Enterprises, Inc., held that the contract governs for fees and costs,
while the right to postpetition interest is purely noncontractual. There-

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88 11 U.S.C. § 1129(b)(2)(A)(i)(II) (1988) ("each holder of a claim of such class [must] receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property"). But cf. Note, Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest, 63 WASH. L. REV. 1041 (1988) [hereinafter A Matter of Interest] (a refreshing, if naive, suggestion that if risk-free treasury rates were used, more reorganizations would be feasible, and litigation costs would be reduced).


89 See id. at 1028-29.
fore, it ought to be open for a court to choose some rate other than the one specified in the contract. But how to choose?

One alternative would be to replicate for the oversecured party "what would have happened if no bankruptcy." This exercise is the fundamental premise of valuing the collateral, and it could easily be borrowed to determine the proper rate of interest. Nevertheless, such an exercise is highly indeterminate. If what would have happened is a foreclosure sale, receipt of cash proceeds, and reinvestment, then the rate of interest ought to be the market rate, not the contract rate. Suppose, however, that the rate agreed upon in the loan contract is higher than market. Then, in our hypothetical universe, perhaps an oversecured party would not foreclose. Instead, she would sit tight for a while and let the lucrative interest accrue. These observations could justify a decision to give the secured party the higher of contract or market rates.

The opposite, however, might be true. If the contract rate is low, then, in a hypothetical no-bankruptcy world, a debtor might keep payments current to prevent default and keep the collateral from being foreclosed. Now default is broadly defined in many agreements to include financial insolvency and the like, so we are supposing that the creditor, receiving regular (below-market) payments, would nevertheless not declare a default. Such an additional assumption, however, is not precluded


Fortgang & Mayer, Valuation in Bankruptcy, 32 UCLA L. REV. 1061, 1082 (1985) [hereinafter Fortgang & Mayer]; cf. Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 164 (1946) (asserting as a reason for no post-bankruptcy interest, the equitable treatment among creditors who charged differing rates in their contracts). The equity mentioned by Vanston would be achieved by making even oversecured creditors take an equalizing market rate.

See In re 433 South Beverly Drive, 117 Bankr. 563, 576 (Bankr. C.D. Cal. 1990) (permitting higher of pre-default contract or market rates, not on the basis of counterfactual speculation, but "[i]n the interest of balancing the preservation of contract rights with the need to compensate for actual damages incurred . . . "); In re Jewell, 25 Bankr. 44, 47 (Bankr. D. Kan. 1982) (allowing oversecured creditors to select which discount factor to use). In In re Loveridge Mach. & Tool Co., 36 Bankr. 159 (Bankr. D. Utah 1983), Judge Clark ruled that § 506(b) does not require the contract rate, but the contract rate was nevertheless appropriate. Id. at 162-65. Even though there was no express sign of hypothetical speculation regarding what would have happened if no bankruptcy proceeding had occurred, an implicit exercise does occur. Id. Judge Clark worried that unless the contract rate was used, one side or the other would receive a "windfall." Id. at 163. This comment reveals a hypothetical vision of a world without bankruptcy in which the contract is allowed to continue by both sides of the transaction.
by the rules of counterfactual speculation (although many would find such creditor acquiescence as “not natural”). In addition, it is a well-established policy of bankruptcy law to invalidate contract clauses that allow default or acceleration based on the debtor’s bankruptcy or insolvency alone. Perhaps the zeal to do so will infect practices in the hypothetical universe. These observations support the view that the secured party should get the lower between the contract and the market rate.

Such a decision—giving the debtor the benefit of the lower between market and contract interest rates—partly resembles another key idea in Chapter 11, the notion of “disimpairment” or “deceleration.” Deceleration is realized by satisfying all of the contractual claims of a creditor, including the cure of past defaults and the payment of whatever postpetition interest is provided for in the loan agreement. As a result, if all of the contractual terms are met, then the creditor is not impaired and thus has no right to vote on the plan. Because this is so, there is no need to give a now disimpaired creditor the present value of her collateral. That is, if the contract rate of interest is promised in a plan which cures all past defaults, the plan can be confirmed even though the disimpaired creditor would be better off with the market rate.

There are some key differences between postpetition interest under deceleration and postpetition interest under Section 506(b). First, while deceleration clearly requires the contract rate, Section 506(b) does not so

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64 The counterfactual exercise is simply the speculation of what would have happened if the facts had been otherwise, in other words, no bankruptcy.
66 A contract rate lower than the market rate was suggested in dictum in Crocker Nat’l Bank v. American Mariner Indus., Inc. (In re American Mariner Indus., Inc.), 734 F.2d 426, 435 n.12 (9th Cir. 1984) (dealing with an undersecured creditor), but the counterfactual reasoning for this conclusion was absent. The reasoning in the text is “logically” possible but is not meant to represent what most practitioners of the counterfactual speculation would in fact produce if they went through the governing “what-if” exercise. See Cardinal Fed. Sav. & Loan Ass’n v. Colegrove (In re Colegrove), 771 F.2d 119 (6th Cir. 1985) (cure as part of disimpairment under § 1325(b)(5)).
67 See 11 U.S.C. §§ 1124, 1322(b)(5) (1988). In curing all defaults, § 1124 makes it clear that defaults based on filings for bankruptcy and the like do not have to be cured. 11 U.S.C. § 1124(2)(A) (1988). The section also undoes any acceleration clause. Hence, the term deceleration is born (though sometimes the term “disimpair” is heard).
70 Furthermore, if the loan contract contains a low predefault rate and a high postdefault rate, the debtor-in-possession is entitled to the lower predefault rate if it disimpairs the secured party by curing all past defaults. Great Western Bank & Trust v. Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.), 850 F.2d 1338, 1342-43 (9th Cir. 1988).
clearly require it. Where the market rate is better for the trustee than the contract rate, deceleration provides no means to capture this favorable market rate, whereas Section 506(b), because it is sufficiently indeterminate, may allow for this. Second, deceleration does not place a ceiling on the interest a secured party can receive, whereas Section 506(b) contains such a ceiling—that is, the secured party can obtain interest only until the debtor’s equity is exhausted. This discussion emphasizes how indeterminate Section 506(b) is if we rely on counterfactuals to determine the “right” rate of interest. We can see that the counterfactual speculation could lead to a high contract rate, a low contract rate, or a market rate.

For those secured parties who obtain a money judgment before bankruptcy, some courts have held that the secured agreement is subsumed into the judgment, so that the secured party may obtain only the legal rate of interest after the judgment. These rulings seem only partially consistent with the counterfactual exercise of “what would have happened if no bankruptcy.” Eventually, the judgment would be enforced; the secured party would get the cash and would (presumably) reinvest it at market rates. After this point, a market rate would seem to be appropriate.

In addition, if the contract has been merged with the judgment, it should also be the case that no “agreement” exists whereby the secured party could obtain post-judgment attorneys’ fees. This seems to have eluded some courts. But this issue was addressed forthrightly by Judge Scholl in *Stendardo v. Federal National Mortgage Association* (In re

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71 See *supra* notes 56-86 and accompanying text.
74 *In re McKillips*, 81 Bankr. 454, 455-57 (Bankr. N.D. Ill. 1987) (barring collection expenses provided in the mortgage agreement, because the agreement was displaced by the judgment); *Schlecht v. Alaska* (*In re Alaska*), 36 Bankr. 236 (Bankr. D. Alaska 1983) (same).
Stendardo). In Judge Scholl’s view, the doctrine of merger is not complete. For example, merger does not eliminate the mortgage lien. Moreover, Judge Scholl thought that the loan agreement itself was competent to repeal the doctrine of merger. Therefore, with the doctrine of merger palpably incomplete, Judge Scholl felt free to hold the clause allowing fees, costs, and charges to be one of those terms which survives the doctrine of merger.

Judge Leif Clark also favored the legal rate in In re Laymon, even though no judgment of foreclosure had been obtained in state law. Clark took the strong position that Ron Pair disenfranchised the contract rate under Section 506(b). But he showed no patience for subjunctive counterfactual speculation about what would have happened absent bankruptcy. Instead, he thought that the federal legal rate should always apply, because the secured party’s claim in bankruptcy is analogous to a

77 Id. at 838.

If the meaning of these cases cited by Judge Scholl is that the agreement must specifically refer to postjudgment interest in order to displace the doctrine of merger, it should be noted that nothing in the FNMA agreement before Judge Scholl reserved the right to charge fees, costs, or charges after a judgment of foreclosure.

79 The charges in question were taxes and insurance premiums paid by FNMA, both costs that directly benefited the debtor. Judge Scholl went on to declare that even if he were wrong on the matter of merger, FNMA would still prevail under the doctrine of unjust enrichment. 117 Bankr. at 840.

81 Id. at 858-59.

82 Judge Clark wrote:

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

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

Id. at 864 (emphasis added).
judgment in a federal court. Judge Clark was inspired to make this ruling by Bankruptcy Code Section 726(a)(5), one of the provisions governing the distribution of the bankrupt estate to the general creditors. According to Section 726(a)(5), if all the creditors have been paid, they are further entitled to interest compensation at the legal rate out of the surplus. This rejection of the contract rate by Section 726(a)(5) reveals a bankruptcy policy of equal treatment as extended to interest rates, including interest rates under Section 506(b). Furthermore, a policy of national uniformity made the federal legal rate superior to various state legal rates.

To summarize, Ron Pair makes it clear that courts are not required, and perhaps are forbidden, to award the contract interest rate. The "what if" exercise that is so common in bankruptcy jurisprudence may be indeterminate, but it at least provides a theory for courts to follow. Competing with the "what if" test is Judge Clark’s well-reasoned opinion in favor of the federal legal rate, on the theory that what is equitable for general creditors facing a surplus is equitable for secured creditors facing excess equity cushions.

B. When Does Interest Begin to Accrue?

Assuming that a secured party is entitled to postpetition interest, another conceptual question must be faced: when does postpetition interest

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According to Judge Clark:

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

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

Id. at 861.

Id. at 117.

Judge King (née Randall), in the court of appeals decision of Timbers of Inwood Forest, listed all of the unverifiable counterfactuals a court would have to invent if undersecured parties had the right to post-bankruptcy interest, implying that if such counterfactuals are necessary, the post-bankruptcy interest entitlement must not exist. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.), 793 F.2d 1380, 1402-05 (5th Cir. 1986), aff'd en banc, 808 F.2d 363 (1987), aff'd, 484 U.S. 365 (1988). The entire Bankruptcy Code, however, is built upon counterfactual exercises—whenever the concept of value is relied upon, a court must undertake such exercises. Therefore, the suggestion that courts must speculate in this manner does not seem to be a persuasive argument against post-petition interest for undersecured parties.
begin to accrue?

We have already discussed the well-established impulse of courts to replicate what would have happened under state law if there had been no bankruptcy. When it seemed as if undersecured parties might obtain postpetition interest as part of adequate protection, courts frequently ruled that interest should begin to accrue only when, in a hypothetical universe of no bankruptcy, the secured party would have foreclosed on collateral, received cash, and reinvested the cash. Of course, this line of cases is all but overruled by Timbers of Inwood Forest.

Oversecured creditors are not necessarily governed by the same counterfactual exercise; rather, they are governed by the language of Section 506(b), which mandates postpetition interest for undersecured parties. On the other hand, we have already seen that the Supreme Court, in United States v. Ron Pair Enterprises, Inc., has ruled that an oversecured party’s right to interest is not governed by the loan agreement. Perhaps this reintroduces the speculative exercise that the adequate protection doctrine had earlier demanded.

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87 See, e.g., Northwest Bank Worthington v. Ahlers (In re Ahlers), 794 F.2d 388, 396 (8th Cir. 1986) (later between time of motion to lift stay or when cash would have been received if no bankruptcy, or, if foreclosure had started before bankruptcy, simply when the cash would have been received and reinvested), rev’d and remanded on other grounds, 485 U.S. 197 (1988); Crocker Nat’l Bank v. American Mariner Indus., Inc. (In re American Mariner Indus., Inc.), 734 F.2d 426, 435 n.12 (9th Cir. 1984) (“to avoid overcompensating the secured creditor, the timing of adequate protection should take account of the usual time and expense involved in repossession and sale of collateral”); Greives v. Bank of Western Ind. (In re Greives), 81 Bankr. 912, 964 (Bankr. N.D. Ind. 1987) (but following the rule that interest starts when the creditor makes a motion to lift the stay); In re Asbridge, 66 Bankr. 894, 900-01 (Bankr. D.N.D. 1986) (“Payments to protect a creditors’ right to a reinvestment return on foreclosure proceeds should not begin until, under state law, the creditor could have . . . reinvested the proceeds.”). The decisions that refuse to award interest until the secured party moves to lift the stay reflect the view that an undersecured party is not entitled to adequate protection until she asks for it. See supra text accompanying notes 48-51. In the context of oversecured parties, this view is irrelevant because the right of an oversecured party to postpetition interest is not dependent on adequate protection.

88 Technically, Timbers of Inwood Forest rejected the claim that adequate protection required postpetition interest for undersecured parties. United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 370-80 (1988). There was a second line of cases which held that interest awards for undersecured parties might be awarded as a matter of judicial discretion. See, e.g., In re Ahlers, 794 F.2d at 396. Perhaps this line of cases still lives, though I would not bet on it.

89 See supra note 9 and accompanying text.


91 See supra notes 13-22 and accompanying text.

92 See supra notes 58-65 and accompanying text. For a case expressly rejecting this counterfactual enterprise, see In re Laymon, 117 Bankr. 856, 864 (Bankr. W.D. Tex. 1990) (instituting instead the federal judgment rate).
If the speculative exercise is reintroduced, it ought to be relatively clear that interest for the oversecured creditors should accrue from the beginning of the bankruptcy proceeding. If the contractual rate of interest is chosen, because one side or the other would have wanted to perpetuate the interest rate provided in the contract, then postpetition interest for oversecured parties immediately accrues upon the filing of the petition. The premise is that, but for the bankruptcy, the status quo of the contract would not have been disturbed. If it is assumed that a foreclosure would have occurred, justifying a market rate, it must also be assumed that contract interest would have accrued against the collateral between the time of the bankruptcy petition and the time of the hypothetical foreclosure. Thus, contrary to the now overruled adequate protection cases, the rule for Section 506(b) ought to be that interest accrues from the very beginning of the bankruptcy proceeding, though perhaps a switch from contract to market rates eventually becomes appropriate.

C. Market Rates of Interest

Suppose that it is decided that a secured party is entitled to a market rate of interest under Section 506(b). How might this rate be identified?

A market rate of interest has three components: (1) a risk-free rate or opportunity cost (competitively determined); (2) an inflationary component; and (3) a risk premium. As instituted in the bankruptcy courts, these factors have been described or ignored in a wide variety of ways. Rather than trying to systematize these cases, this article sets forth some maxims, derived from the case law, that try to capture all or part of these factors.

(1) Choose the risk-free rate. Risk can be ignored because a bankruptcy court has already determined that the plan is feasible. If risky, it should not have been confirmed.

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93 Remember that we are dealing with oversecured parties here.
94 E. Brigham, Fundamentals of Financial Management 60-61 (4th ed. 1986). Properly speaking, one should also consider the monopoly power a lender has over a borrower, which might stem from superior knowledge that the actual risk is less than the market perception. Thus, a specific creditor who charges the market rate might well enjoy a super-competitive profit.
96 In re Wilkinson, 33 Bankr. 933, 936-37 (Bankr. S.D.N.Y. 1983). Contra Farm Credit Bank v. Fowler, (In re Fowler), 903 F.2d 694, 698 (9th Cir. 1990) ("[f]inding that a reorganization plan is feasible does not necessarily mean that the risk of default is small").
(2) Choose the risk-free rate, but to account for market fluctuations, take the average treasury rate within six months of the filing of the bankruptcy petition for bonds of a duration similar to that of the reorganization plan.\textsuperscript{97}

(3) You cannot choose the risk-free “short term treasury rate.”\textsuperscript{98} A risk factor must be added, but it must not be an arbitrary risk factor.\textsuperscript{99} By virtue of the rules of bankruptcy, however, it should be recognized that debtors in bankruptcy are less risky, for secured parties, than nonbankrupt debtors.\textsuperscript{100}

(4) Choose the floating rate set by Congress in Internal Revenue Code Section 6621,\textsuperscript{101} but add a risk factor.\textsuperscript{102}

(5) Choose “the rate which regional lenders of similar loans . . . would actually charge persons similarly situated to the debtor on the open market, \textit{absent the fact of bankruptcy}.”\textsuperscript{103}

(6) You cannot use the unadorned prime rate unless the debtor-in-possession could actually qualify for it in the market.\textsuperscript{104}

(7) Choose the borrower’s cost of funds, plus a premium for the risk the debtor poses.\textsuperscript{105} This reimburses the creditor for the cost of replacing

\textsuperscript{97} In re Wilkinson, 33 Bankr. at 936-37 & n.4; cf. In re Loveridge Mach. & Tool Co., 36 Bankr. 159, 170 (Bankr. D. Utah 1983) (add interest to the applicable risk-free rate to compensate for risks in the plan).

\textsuperscript{98} United States v. Camino Real Landscape Maintenance Contractors, Inc., 818 F.2d 1503, 1506 (9th Cir. 1987). Fortgang and Mayer point out: “Government rates are influenced by the perfect liquidity of the market for government securities. Interest on treasuries is not subject to state tax. By contrast, private loans are liquid even if risk-free, and their interest is taxable.” Fortgang & Mayer, \textit{supra} note 62, at 1118-19.

\textsuperscript{99} In re Fowler, 903 F.2d at 698; In re Park Ave. Partners, L.P., 95 Bankr. 605, 614 (Bankr. E.D. Wis. 1988). Nevertheless, the process by which risk premiums are chosen is rarely made apparent in the opinions. See, e.g., In re Smithfield Estates, Inc., 52 Bankr. 220, 225 (Bankr. D.R.I. 1985) (asserting a 2% risk premium without further explanation).

\textsuperscript{100} In re Claeyts, 81 Bankr. 985, 993 (Bankr. D.N.D. 1987) (neglecting to explain why this is so); Note, \textit{Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy}, 50 U. Chi. L. Rev. 305, 324 (1983) (emphasizing the role that the super priority in § 507(b) has in reducing risk to secured parties). Some authorities also assert that the judge’s determination of feasibility is evidence of less risk. See, e.g., Comment, \textit{Bankruptcy Reform Act of 1978: Chapter 13 Cramdown of Secured Creditors}, 1981 Wis. L. Rev. 333, 357 n.131; cf. In re Wilkinson, 33 Bankr. 933, 937 (Bankr. S.D.N.Y. 1983) (making this determination \textit{conclusive} evidence of no risk).

\textsuperscript{101} The rate charged by the I.R.S. is the rate for short-term federal securities plus 3 percent. See 26 U.S.C. § 6621(a)(2) (1988).


\textsuperscript{103} In re Shannon, 100 Bankr. 913, 936 (Bankr. S.D. Ohio 1989) (citing cases).

\textsuperscript{104} In re Park Ave. Partners, L.P., 95 Bankr. 605, 614 (Bankr. E.D. Wis. 1988).

\textsuperscript{105} In re Hardzog, 74 Bankr. 701, 704 (Bankr. W.D. Okla. 1987), \textit{aff'd}, 113 Bankr. 718 (W.D. Okla. 1989), \textit{rev'd}, 901 F.2d 858 (10th Cir. 1990); Campbell v. Ford Motor Credit Co. (\textit{In re}}
the funds that the debtor-in-possession withholds.

(8) The proper rate is what the specific creditor would charge on a
similar loan,\(^{106}\) or the average interest rate the specific creditor would
charge to all of its customers.\(^{107}\)

(9) The proper rate is what the specific creditor could earn if that
creditor were given cash and could reinvest it.\(^{108}\)

(10) The proper rate should not be creditor-specific;\(^{109}\) instead, the
regional rate that creditors generally receive should be used.\(^{110}\)

(11) Absent any information to the contrary, presume the contract
rate\(^{111}\) or the legal rate.\(^{112}\)

(12) Regardless of the market, use the contract rate: "the parties
agreed it was a fair return to the secured creditor over an extended
period of time."\(^{113}\)

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\(^{106}\) Chrysler Credit Corp. v. Cooper (In re Cooper), 11 Bankr. 391, 394 (Bankr. N.D. Ga.
1981); In re Trigwell, 67 Bankr. 808, 810 (Bankr. C.D. Cal. 1986). Judge Robert Kresse has
remarked:

In light of the fact that the Code sections dealing with deferred plan payments are intended
to compensate the creditor for the cost associated with the delay in receiving the value of its
secured claim, it makes sense to at least consider what the creditor would earn under simi­
lar circumstances.

Kresse!, Calculating the Present Value of Deferred Payments Under a Chapter 12 Plan: A New
Twist to an Old Problem, 62 AM. BANKR. L.J. 313, 316 (1988). This seems dubious. The purpose
of the cramdown provision, at least where the secured party is to be given debt instruments with a value
equal to the allowed secured claim, is not to compensate the creditor for delay. The purpose is to
equate the value of the debt instruments with the value of the allowed secured claim. 124 CONG. REC.
H11,103 (Sept. 28, 1978); 124 CONG. REC. S17,420 (Oct. 6, 1978).

\(^{107}\) In re T. Neff, 60 Bankr. 448, 457 (Bankr. N.D. Tex. 1985), aff'd, 785 F.2d 1033 (5th Cir.
1986).

\(^{108}\) Gincastro v. Fairlawn Credit Union (In re Gincastro), 48 Bankr. 662, 666 (Bankr. D.R.I.
1985).

\(^{109}\) In re D. Neff, 89 Bankr. 672, 677 (Bankr. S.D. Ohio 1988) (rejecting claim that the lender's
usual price is the same as a competitive market rate); In re Wolf, 61 Bankr. 1010, 1012 (Bankr. N.D.
Iowa 1986) (criticizing this standard for locking in exorbitant or unfair rates that a specific creditor
has been able to charge).

\(^{110}\) Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427, 431 (6th Cir. 1982).


\(^{112}\) In re C & P Gray Farms, Inc., 70 Bankr. 704, 707 (Bankr. W.D. Mo. 1987); Ford Motor

\(^{113}\) In re Einspahr, 30 Bankr. 356, 356 (Bankr. E.D. Pa. 1983). This maxim has been criticized
on various grounds. For example, a contract rate reflects anticipated collection expenses, but in bank­
ruptcy, those collection expenses might be different. In re Fisher, 29 Bankr. 542, 545 (Bankr. D.
Kan. 1983). The Fisher court, however, overlooks the fact that bankruptcy itself might have been the
anticipated mode of collecting. See Fortgang & Mayer, supra note 62, at 1120. Also, the market may
have changed, or the contract may reflect a super-competitive profit. In re Wilkinson, 33 Bankr. 933,
936 (Bankr. S.D.N.Y. 1983); In re Fisher, 29 Bankr. at 546; see also In re Fisher, 29 Bankr. at 549
(13) Creditors should not receive a profit. Any profit should be removed from the market rate.\textsuperscript{114}
(14) Add something to the prime rate to cover inflation.\textsuperscript{115}
(15) Use the same rate in all cases because it is administratively convenient.\textsuperscript{116}
(16) "The cost of money to the creditor plus a reasonable rate of return."\textsuperscript{117}

IV. "FEES, COSTS, OR CHARGES"

A. Collection Costs

Not only may oversecured parties obtain postpetition interest, but they may also obtain "any reasonable fees, costs, or charges provided for under the agreement under which such claim arose."\textsuperscript{118} Of course, such expenses can only be recovered out of the debtor's equity cushion in the collateral.\textsuperscript{119} If there is no equity cushion, there is no recovery against the bankrupt estate.

From the language of Section 506(b), some background assumptions should be apparent. First, the loan agreement must entitle the secured party to collect these costs.\textsuperscript{120} Thus, whereas Ron Pair emphasizes that the contract is irrelevant for setting the interest rate, it does quite the

\textsuperscript{114} In re Fisher, 29 Bankr. at 546; Chrysler Credit Corp. v. Cooper (In re Cooper), 7 Bankr. 537, 542 (Bankr. N.D. Ga. 1980).

\textsuperscript{115} In re Bay Area Servs., 26 Bankr. 811, 814 (Bankr. M.D. Fla. 1982) (10% added). One would think that the prime rate already includes an inflation factor, which would give the creditor a double benefit under this formula.

\textsuperscript{116} In re Fisher, 29 Bankr. at 552 (treasury rate plus 1% in all Chapter 13 cases); In re Fi-Hi Pizza, 40 Bankr. 258, 272 (Bankr. D. Mass. 1984) (federal tax rate plus 2.5% in all cases); see A Matter of Interest, supra note 55 (arguing generally along these lines). Contra United States v. Neal Pharmacal Co., 789 F.2d 1283, 1289 (8th Cir. 1986) (Section 1129(a)(9)(C) compels a case-by-case analysis); cf. In re Loveridge Mach. & Tool Co., 36 Bankr. 159, 168 (Bankr. D. Utah 1983) (administrative convenience should be a factor only in Chapter 13, not in Chapter 11).

\textsuperscript{117} In re Burris, 102 Bankr. 822, 825 (Bankr. E.D. Okla. 1989) (this formula leaves out any risk factor, which cannot be characterized as part of a reasonable return).

\textsuperscript{118} 11 U.S.C. § 506(b) (1988); see supra text accompanying note 9.


\textsuperscript{120} U.C.C. § 9-504(1)(a) does authorize the collection of sales expense out of the collateral even if there is no contractual language to this effect, but this ends up being largely irrelevant in bankruptcy unless these expenses have already accrued by the time of bankruptcy. See 11 U.S.C. § 362 (1988).
As these fees and charges come directly out of the pockets of the general creditors, courts seem to read these agreements stingily. According to some authorities, if attorneys' fees may be collected in case of foreclosure, they may not be collected under Section 506(b), at least where a rehabilitation proceeding does not contemplate a sale free and clear of liens. This particular instance of stinginess seems rather unfair in light of the fact that the automatic stay prohibits the very foreclosure in question.

Second, even if the contract provides for collection, the contract must be valid and enforceable under state law. Some cases seem to be contrary, asserting that state law is irrelevant, but many of these cases merely refute the idea that if state law approves of a contract clause, the federal courts must do likewise. Instead, they could be taken to establish the

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See In re Cuisinarts, Inc., 115 Bankr. 744, 749 (Bankr. D. Conn. 1990) (contract authorizing collection expenses did not permit secured party to claim reimbursement for the services of investment banker); In re LaRoche, 115 Bankr. 93, 96-97 (Bankr. N.D. Ohio 1990) (reference in loan agreement to 38 C.F.R. § 36.4313(b), in which the Veterans Administration agrees to be surety for attorneys' fees, did not comprise debtor's promise to reimburse these expenses).


One important issue under state law is whether a buyer of collateral who is not a party to the security agreement takes subject to the ability of the secured party to increase the size of the lien by incurring collection expenses. Suppose, for example, that X signs a security agreement allowing SP to incur collection expenses which can be added to the amount of the secured claim. X then sells the collateral to D, and D's property continues to be encumbered by SP's security interest. If SP now incurs collection expenses, is it chargeable against D's property? For a negative answer in a real estate case, see In re Club Assocs., 107 Bankr. 794 (Bankr. N.D. Ga. 1989). Under the UCC, this issue turns on the priority assigned to non-advance value. See generally Schroeder & Carlson, Future Nonadvance Obligations Under Article 9 of the UCC: Legitimate Priority or Unwarranted Squeez-Out?, 102 BANKING L.J. 412 (1985).

See, e.g., Blackburn-Bliss Trust v. Hudson Shipbuilders, Inc., (In re Hudson Shipbuilders, Inc.), 794 F.2d 1051 (5th Cir. 1986); In re Wonder Corp., 72 Bankr. 580, 591 (Bankr. D. Conn. 1987) (“While it is clear that courts must look to the underlying contract as the initial focal point, it is equally clear that after bankruptcy, it is § 506(b), not state law, through which that look is focused.”), aff'd, 82 Bankr. 186 (D. Conn. 1988); In re Elmwood Farm, Inc., 19 Bankr. 338, 341 (Bankr. S.D.N.Y. 1982) (“the bankruptcy court need not look to local law in the context of entitlement to attorneys' fees”).

A typical example of the ambiguity of these cases is Joseph F. Sanson Inv. Co. v. 268 Ltd. (In re 268 Ltd.), 789 F.2d 674 (9th Cir. 1986), where Judge Goodwin writes:

A concededly unreasonable fee provision might be enforceable under state law, whereas a
rule that while state law supplies the *minimum* of what is reasonable, federal law may intervene to impose a *higher* standard.

Two important cases, however, are clearly to the contrary, asserting that it is open for federal bankruptcy law to choose a lower standard than state law would allow. In *Unsecured Creditors' Committee v. Walter E. Heller & Co., Southeast (In re Stephenson Supply Co.)*, a North Carolina statute required the creditor to notify the debtor of default. If the debtor paid within five days, an agreement providing for attorneys' fees is cancelled. The secured party, however, never gave notice. The court, nevertheless, awarded attorneys' fees pursuant to the agreement. Judge Ervin's opinion seems to require that there be at least an agreement, but the enforcement of that agreement no longer seems to be a matter of only state law. Here, federal law approved a fee that state law would have struck down.

The second case, *In re A.J. Lane & Co.*, presents a detailed justification for the position that while the parties must have an agreement, state law shall be ignored in enforcing this agreement. In that case, Judge Queenan pointed out that Congress considered an earlier version of Section 506(b) which contained the language: "to the extent collectible under applicable law." This language was deleted in the final version of Section 506(b), implying that applicable law is now irrelevant.

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reasonable one might be unenforceable for reasons unrelated to the size of the fee. Thus, we cannot agree that by requiring that contractual fee agreements be reasonable Congress meant only that they must be enforceable under [state] law.

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118 768 F.2d 580 (4th Cir. 1985).
117 Id. at 581.
116 Id. at 582 n.3.
115 Id. at 582.
114 Id. at 585.
113 Id. at 580 (4th Cir. 1985) ("in rejecting the House version of § 506(b), Congress intended to abrogate the pre-existing requirement that attorneys' fees agreements were enforceable only in accordance with state law").
112 Id. at 583-85.
110 Id. at 823-25.
109 Id.
108 In describing the newly revised § 506(b), Senator DeConcini and Representative Edwards both stated: "If the security agreement between the parties provides for attorneys' fees, it will be enforceable under title 11, notwithstanding contrary law." *In re A.J. Lane & Co.*, 113 Bankr. at 824 (citing 124 CONG. REC. H11095 (daily ed. Sept. 18, 1978); 124 CONG. REC. S17211 (daily ed. Oct.
When it came time to decide the case before him, however, Judge Queenan held a contract clause pertaining to a prepayment penalty unenforceable. Therefore, it was unnecessary to decide whether federal law might uphold a contract that state law would strike down.\(^{187}\)

Even if courts disagree on whether state law sets a *minimum* standard of reasonableness, they all agree that the expenses must still be reasonable according to a separate *federal* standard, not a state law standard.\(^{188}\) In addition, secured parties must comply with Bankruptcy Rule 2016(a)\(^{189}\) and any local bankruptcy rules that apply to the trustee's at-

\(^{6, 1978}\)).

\(^{187}\) Other arguments offered by Judge Queenan are less persuasive. Noting that the old Bankruptcy Act did require that the contract pass muster under state public policy, *id.* at 823 (citing Security Mortgage Co. v. Powers, 278 U.S. 149, 153-54 (1928)), Judge Queenan felt that the very enactment of § 506(b) indicated a desire to change this rule. *Id.* at 824-25. Contrary legislative history is dismissed by Judge Queenan as "not . . . critical." *Id.* at 824. This argument, however, fails. There are many instances where Congress merely codified old law without attempting to change it. Equitable subordination under § 510 is an example. See H. REP. NO. 95-595, 95th Cong., 1st Sess. 359, *reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6316.

Furthermore, Judge Queenan reasoned that the trustee’s attorneys’ fees are subject to a "reasonableness" rule, see 11 U.S.C. § 330(a)(1) (1988), that is clearly federal. 113 Bankr. at 825. Therefore, Congress must have intended a similar federal standard for § 506(b). *Id.* Even if Congress had such an intent, it remains to be established whether Congress intended to *preempt* state law, allowing contract clauses (pertaining to attorneys’ fees of other matters) which have been condemned by state policy to survive in federal court.


Three authors claim that pre-petition attorneys’ fees are not subject to the federal "reasonableness" test. Klausner, Pachulski & Godshall, *Chapter 11—The Bank of Last Resort*, 45 Bus. Law. 261, 277 (1989) [hereinafter *The Bank of Last Resort*]. Bankruptcy courts, however, are courts of equity and would seem to have plenty of power to subordinate or even to disallow unreasonable pre-petition attorneys’ fees.

\(^{189}\) Bankruptcy Rule 2016(a) provides:

(a) *Application for Compensation or Reimbursement.* An entity seeking interim or final compensation for services, or reimbursement of necessary expenses, from the estate shall file with the court an application setting forth a detailed statement of (1) the services rendered, time expended and expenses incurred, and (2) the amounts requested. An application for compensation shall include a statement as to what payments have theretofore been made or promised to the applicant for services rendered or to be rendered in any capacity whatsoever in connection with the case, the source of the compensation so paid or promised, whether any compensation previously received has been shared and whether an agreement or understanding exists between the applicant and any other entity for the sharing of compensation received or to be received for services rendered in or in connection with the case, and the particulars of any sharing of compensation or agreement or understanding
Therefore, some collection expenses that would be allowed under state contract law would not be allowed in bankruptcy.

Among the things that have been proclaimed reasonable are expected items such as attorneys' fees incurred before bankruptcy and appraisal fees, but some surprising, less expected, items have also been allowed. One court at least hinted that interest on collection expenses would be awarded if the contract so provided (although the contract in that case did not so provide). Also, attorneys' fees for representation outside the bankruptcy case as well as in the bankruptcy case have been allowed, even if the attorneys' actions were detrimental to the estate. Thus, the estate must subsidize whatever boutique state-of-the-art services the secured party would like, provided only that the services are "reasonable." At least one court, however, has worried about the adverse incentives upon creditors and has suggested that the actions must be those which similarly situated creditors would take where "the creditor reasonably believed that the services employed were necessary to protect his interests in

therefore, except that details of any agreement by the applicant for the sharing of compensation as a member or regular associate of a firm of lawyers or accountants shall not be required.


140 In re Danise, 112 Bankr. 492, 495 (Bankr. D. Conn. 1990).
141 Dalessio v. Pauchon (In re Dalessio), 74 Bankr. 721, 724 (Bankr. 9th Cir. 1987); In re Lederman Enters., Inc., 106 Bankr. 674, 678 (Bankr. D. Colo. 1989).
143 In re Stoecker, 114 Bankr. 980, 986 (Bankr. N.D. Ill. 1990) (discovery expenses in nonbankruptcy challenge to secured party's priority).
144 In re Nicfur-Cruz Realty Corp., 50 Bankr. 162, 167-68 (Bankr. S.D.N.Y. 1985); In re Carey, 8 Bankr. 1000, 1004 (Bankr. S.D. Cal. 1981). But see In re Wiltwyck School, 34 Bankr. 270, 275-76 (Bankr. S.D.N.Y. 1983) (where the contract provided for expenses relating to "the lien of the mortgage," expenses incurred in resisting the trustee's motion for § 506(c) did not qualify under the agreement); In re Diaz Figueroa, 102 Bankr. 293, 295 (Bankr. D.P.R. 1989). The Diaz Figueroa court stated:

Under the terms of the contract, [the secured party's assignee] is not entitled to the attorneys' fees requested because it did not refer the case to its attorney for the purposes of collecting the loan by judicial means or instituting an action for repossession of the automobile. Rather, it was referred . . . to defend against the trustee's [claim] that the notice of the assignment had been filed too late.

In re Diaz Figueroa, 102 Bankr. at 295; see First Fed. Sav. & Loan Ass'n v. Silberman (In re Silberman), 5 Bankr. 686 (Bankr. M.D. Fla. 1980) (litigation costs to lift stay to be borne by secured party).
144 "A court should not reward a creditor whose overly aggressive attorney harasses and opposes the debtor at every stage of the bankruptcy proceeding, nor should an oversecured creditor be given a blank check to incur fees and costs which will automatically be reimbursed out of its collateral." Dalessio v. Pauchon (In re Dalessio), 74 Bankr. 721, 723 (Bankr. 9th Cir. 1987).
the debtor’s property.”

One court has allowed attorneys’ fees for pursuing a guarantor, who would step into the shoes of the secured party and be subrogated in the debtor’s bankruptcy. This seems questionable. Section 506(b) should be understood to contemplate fees, costs, and charges relating to the enforcement of the secured claim against the debtor’s estate, not a claim against someone other than the debtor.

Attorneys’ fees might be denied if the self-interested motion is unsuccessful. Similarly, fees incurred to help general creditors by drafting a Chapter 11 plan or fees generated by cooperating in a criminal proceeding against the debtor are also not allowed. Furthermore, some courts are simply hostile to the idea that the estate should pay for self-serving motions of the secured party.

Attorneys’ fees need not be paid in cash. Instead, the amount may be added to the secured claim and paid later. One court even holds that for the purposes of “curing” defaults in order to decelerate a loan under Section 1124(2), it is sufficient to add such expenses to the secured claim instead of paying those amounts in cash.

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146 Id. at 723; In re Wonder Corp., 72 Bankr. 580, 591 (Bankr. D. Conn. 1987) (creditors are entitled to recovery of fees and costs for “aggressive representation” but not “excessive caution or overzealous advocacy”), aff’d, 82 Bankr. 186 (D. Conn. 1988). In addition, fees for novel appeals that might help the secured party in future business, but which are not reasonable in light of the size of the secured party’s claim in the bankruptcy at hand, are not recoverable. In re Josephs, 108 Bankr. 654, 657 (Bankr. N.D. Ill. 1989).


148 In re Kroh Bros. Dev. Co., 105 Bankr. 515, 528 (Bankr. W.D. Mo. 1989); see In re Wonder Corp., 72 Bankr. at 591 (disallowing fees for frivolous appeals and for appeals from unsuccessful attempts to establish secured party entitlements under § 506(b)). In In re Swackhammer, 115 Bankr. 509 (Bankr. W.D. Pa. 1990), Judge Bentz disallowed fees incurred as the result of a motion to lift the automatic stay where the creditor was highly pessimistic about the value of the collateral. Id. at 510. Judge Bentz stated: “We will not decide whether such a gross disparity may indicate that [the secured creditor] made its allegations with a reckless disregard for the truth, in a single minded effort to recover its collateral without regard to the rights of the other parties in the proceeding.” Id. Indeed, why decide when innuendo is perfectly adequate to make the point?

149 In re Lederman Enters., Inc., 106 Bankr. at 678.


152 Florida Partners Corp. v. Southeast Co. (In re Southeast Co.), 868 F.2d 335, 340 (9th Cir. 1989); In re Colvin, 57 Bankr. 299, 302 (Bankr. D. Utah 1986). Indeed, if such expenses are paid out in cash, the equity cushion is preserved for new expenses and postpetition interest, implying that the equity cushion is the condition for but not the limit of § 506(b) entitlements. See supra note 53 and accompanying text.

153 In re Southeast Co., 868 F.2d at 339-40. There is some legislative history. The Senate report on the Bankruptcy Reform Act indicates that no “redemption premium” is required to cure defaults
B. Prepayment Premiums

Prepayment premiums and lump sum default penalties are common loan agreement provisions. Although both clearly fall within the concept of "charge" as used in Section 506(b), the two are arguably distinguishable in one respect. According to some authorities, a prepayment premium—payable only at the option of the debtor and never at the option of the creditor—is the price a debtor has agreed to pay for such an option, and as such, it is not a penalty for breach of contract in the nature of a liquidated damage clause. Nevertheless, pursuant to the express command of Section 506(b), the charges must be reasonable, and thus they will still be reviewed. On the other hand, one court has ruled that any prepayment of a loan is a breach, even if it is allowed by the contract in exchange for paying a premium. Therefore, if the prepayment is a breach, the law of liquidated damages will be applied. This is perhaps a matter of state law, but in any case it is subject also to a potentially stricter federal requirement of reasonableness. Many courts, however, do not indicate whether they are following a state or a federal rule.

in the course of disimpairment under § 1124. S. REP. No. 95-989, 95th Cong. 2d Sess. 120, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5906. Judge Bufford, however, declares that this brief remark is irrelevant to the meaning of § 506(b). In re Skyler Ridge, 80 Bankr. 500, 508-09 (Bankr. C.D. Cal. 1987).


166 Imperial Coronado Partners, Ltd. v. Home Fed. Sav. & Loan Ass'n (In re Imperial Coronado Partners, Ltd.), 96 Bankr. 997, 1001 (Bankr. 9th Cir. 1989) (limiting secured party to actual damages as measured by the difference between the market and contact rates of interest).

167 In re A.J. Lane & Co., 113 Bankr. at 827.

168 For a discussion of the validity of a liquidated damages clause, see infra note 200 and accompanying text.

169 In re Kroh Bros. Dev. Co., 88 Bankr. 997, 999 (Bankr. W.D. Mo. 1988). For a case in which late charges were interpreted to be "interest on arrears" and, hence, illegal under relevant state law, see In re Jordan, 91 Bankr. 673 (Bankr. E.D. Pa. 1988). One case held that state law was preempted by regulations promulgated by the Federal Home Loan Bank Board, not by bankruptcy law. E.g., In re Imperial Coronado Partners, Ltd., 96 Bankr. at 999. For our purposes, this opinion supports the idea that at least a nonbankruptcy standard is relevant.

166 As stated in the previous section, see supra notes 126-140 and accompanying text, some courts take the position that state law is irrelevant; federal law might enforce an agreement that state law would condemn. See In re A.J. Lane & Co., 113 Bankr. at 823-25.

164 For examples of nonspecificity involving default penalties, see Mack Fin. Corp. v. Ireson, 789 F.2d 1083 (4th Cir. 1986) (5% of late installment payment as penalty held reasonable because it was allowed under Virginia law); In re LHD Realty Corp., 726 F.2d 327, 332-33 (7th Cir. 1984) (4% of late installment payment as penalty held reasonable); Dalessio v. Pauchon (In re Dalessio), 74 Bankr.
Loan contracts sometimes provide that the prepayment premium is due only if the debtor elects to prepay, not if the creditor elects to accelerate upon default. This raises the issue whether a voluntary petition in bankruptcy is a voluntary acceleration of the loan. If it is a voluntary acceleration, the prepayment premium is automatically triggered as soon as the debtor voluntarily files for bankruptcy.

Some cases, not dealing with prepayment premiums, indicate that a bankruptcy petition, even if voluntarily filed by the debtor, is not to be considered a voluntary act of the debtor. While these cases do not involve prepayment premiums, their import would be that a debtor does not owe the premium only by virtue of filing for bankruptcy. In United States v. Technical Knockout Graphics, Inc. (In re Technical Knockout Graphics, Inc.), Judge Leavy made a creative point: because bankruptcy amounts to a transfer of assets to a trustee who is not the debtor, if the trustee is deemed to prepay or accelerate a loan, then it is not the debtor’s voluntary choice, but someone else’s, even where the debtor initiated the proceeding by filing a voluntary bankruptcy proceeding. Judge Leavy,
however, overlooked the fact that the petition itself accelerates the loan, which is usually the voluntary decision of the debtor. In Chapter 11, it is just as possible to decelerate the loan, and where the Chapter 11 trustee does not do so, one court held that this passive failure to decelerate constituted a deliberate choice to prepay the loan. Hence, the prepayment penalty was applicable.

A similar point along the same line might also help defeat the equation of a voluntary bankruptcy petition with a choice to prepay. As has already been emphasized, a bankruptcy trustee is a hypothetical lien creditor. If bankruptcy causes a transfer from the debtor to the trustee as if by judicial lien, then it could be said that bankruptcy is involuntary because judicial liens are involuntary transfers. This hypothetical characterization would help defeat the idea that a voluntary bankruptcy petition amounts to the voluntary prepayment by the debtor.

In re LHD Realty Corp. is consistent with the view that bankruptcy petitions do not constitute the debtor’s choice to prepay. In that case, the secured party sought both to have the automatic stay lifted and to preserve its right to a prepayment premium. The Seventh Circuit held that this affirmative motion constituted creditor acceleration, and hence, the prepayment premium was not due and owing. This decision implies payments to cover trust fund tax liability first. United States v. Energy Resources Co., 110 S. Ct. 2139, 2140 (1990). Perhaps this opinion does not contradict Technical Knockout for the exact point stated. Technical Knockout, 833 F.2d 797. While Technical Knockout characterized the tax payment as not voluntary, Energy Resources held only that a bankruptcy court can order such a payment to extinguish a trust fund debt, for which corporate officers are liable, over ordinary taxes, for which they are not liable. This power to allocate payments might exist regardless of whether those payments are designated voluntary or involuntary. Energy Resources should not stand for the proposition that the debtor-in-possession, as fiduciary, is free to cater to the self-interest of its officers (though admittedly that is certainly its effect).


E.g. Imperial Coronado Partners, Ltd. v. Home Fed. Sav. & Loan Ass’n (In re Imperial Coronado Partners, Ltd.), 96 Bankr. 997, 1000 (Bankr. 9th Cir. 1989). In a slight variation, Judge Yacos argued that even if the trustee’s choice is the debtor’s choice, in Chapter 7 no choice exists because payment must be on an accelerated basis. In re Public Serv. Co., 114 Bankr. 813, 817-19 (Bankr. D.N.H. 1990). This lack of choice compels the view that the contractual prepayment penalty is not due and owing because the trustee has not “elected” to prepay. This view, of course, overlooks the fact that if the debtor has filed a voluntary bankruptcy petition in Chapter 7, the debtor has voluntarily put the trustee in this predicament.

See supra notes 163-167 and accompanying text.


726 F.2d 327 (7th Cir. 1984).

Id. at 330-33.

Id. at 329-30.

Id. at 331.
that the bankruptcy petition did not represent the debtor's choice to prepay the loan.

*LHD Realty* implies an interesting and painful incentive for secured creditors.\(^{174}\) Under some views of adequate protection, a secured party is not entitled to adequate protection of her collateral until she makes a motion to lift the stay.\(^{175}\) If this is the rule,\(^{176}\) the secured party is put to the choice between forfeiting her right to a prepayment interest penalty or forfeiting adequate protection of the collateral. If she moves for relief from the stay, she gains adequate protection but loses the prepayment premium. Conversely, if she refrains from such a motion, she keeps the premium but loses any right to adequate protection.

Along the same lines as *In re LHD Realty*\(^{177}\) is *In re Public Service Co. of New Hampshire*,\(^{178}\) which implied that even though the petition is not an election to prepay, a presentation of a Chapter 11 plan in which the secured claim is *in fact* prepaid is an election to prepay.\(^{179}\) In this case, however, the Chapter 11 plan had been formed by the creditors, not the debtor, although the debtor had consented to it.\(^{180}\) Therefore, the court concluded that the debtor had *not* elected to prepay and did not owe the prepayment premium.\(^{181}\)

One court, however, has ruled that a voluntary bankruptcy petition is tantamount to an election to prepay.\(^{182}\) This characterization is consistent


\(^{175}\) See, e.g., *In re Kain*, 86 Bankr. 506, 512 (Bankr. W.D. Mich. 1988) ("Colloquially expressed, if you don't ask for it, you won't get it."). This view is based on Bankruptcy Code § 363(e), which provides:

> at any time, on request of an entity that has an interest in property used, sold, or leased ... by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.


\(^{177}\) As previously discussed, the court held that the petition is not an election to prepay but that a subsequent event might constitute a creditor's option to declare default. See supra notes 170-176 and accompanying text.


\(^{179}\) Id. at 818-19.

\(^{180}\) Id. at 816.

\(^{181}\) Id. at 818-19.

\(^{182}\) *In re Skyler Ridge*, 80 Bankr. 500, 507 (Bankr. C.D. Cal. 1987). The court went on, however, to find the prepayment penalty to be void as unreasonable. *Id.; see Imperial Coronado Partners, Ltd. v. Home Fed. Sav. & Loan Ass'n* (*In re Imperial Coronado Partners, Ltd.*), 96 Bankr. 997, 1000 (Bankr. 9th Cir. 1989) (although the creditor accelerated the payments, the debtor had the right to
with some famous, though strange, state law. In \textit{Sharon Steel Corp. v. Chase Manhattan Bank, N.A.}, a debtor was in the process of a private, voluntary liquidation of its assets. After a series of sales, it sold the remaining assets (thirty-four percent of the original assets of the company) to Sharon Steel. According to numerous indenture agreements to which the debtor was a party, the debtor had the right to sell "all assets" to a buyer who would assume the debts, without throwing the debentures into default. As a buyer of "all assets" who had assumed the debt, Sharon Steel took the position that it was entitled to avoid default.

The indenture trustees disagreed. They thought that "all assets" had to be measured before the piecemeal liquidation had commenced. Accordingly, Sharon Steel was the buyer of \textit{substantially less} than "all assets." The indenture trustees then demanded that debtor cure "the default . . . within 90 days or that the debentures be redeemed." Sharon in turn sought a court declaration that there was no default and that, at any rate, it owed no prepayment premium.

Judge Winter, for the Second Circuit, ruled that Sharon Steel did not qualify as a buyer of all of the assets, and therefore, the debentures were in default. Nevertheless, the sale to Sharon Steel (a liquidation analogously analogous to a voluntary bankruptcy petition) was deemed to be tantamount to the choice to prepay. Hence, the premium was due. According to this view, any conscious choice by the debtor to default is a debtor's choice to prepay, or, in the words of a commentator: "In effect, the holders requested—and got—specific performance of the redemption reinstatement, and having failed to do so, the acceleration became the debtor's choice); cf. United States v. Energy Resources, Inc., 110 S. Ct. 2139 (1990) (debtor-in-possession had the power to designate payments to the trust fund tax liability rather than another tax owed to the IRS).

\begin{itemize}
  \item \textit{Id.} at 1045.
  \item \textit{Id.} at 1046.
  \item \textit{Id.} at 1046 n.11.
  \item \textit{Id.} at 1946-47.
  \item \textit{Id.} at 1047.
  \item \textit{Id.} at 1049.
  \item \textit{Id.} at 1047.
  \item \textit{Id.}
\end{itemize}

\begin{itemize}
  \item \textit{Id.} at 1051-52. This part of the case is lucidly discussed in Bratton, \textit{The Interpretation of Contracts Governing Corporate Debt Relationships}, 5 CARDOZO L. REV. 371, 387-88 (1984) [hereinafter Bratton].
  \item Sharon Steel Corp. v. Chase Manhattan Bank, 691 F.2d 1039, 1053 (2d Cir. 1982).
\end{itemize}
provision.\textsuperscript{194}

If private liquidation is analogized to a voluntary bankruptcy petition, this glimpse of state law heavily suggests that the bankruptcy petition itself is the debtor's voluntary choice to prepay the loan. Accordingly, the prepayment penalty is due whenever a voluntary petition in bankruptcy is filed. Of course, if these latter views prevail, the prepayment premium becomes a fully secured claim payable under Section 506(b).\textsuperscript{195} Hence, such reasoning is very expensive for the general creditors.

C. \textit{Default Penalties}

Separate from prepayment premiums, which are chosen by the debtor, are higher postdefault penalties and interest rates, which are imposed by the creditors. Lump sum penalties are routinely scrutinized under the state law of liquidated damages.\textsuperscript{196} In a leading case on this subject, \textit{Ferrari v. Barclays American/Business Credit, Inc. (In re Morse Tool, Inc.)},\textsuperscript{197} the secured party claimed a large "termination fee" as a collection expense under Section 506(b).\textsuperscript{198} Judge Kenner treated this fee as a "liquidated damage" clause and looked to Connecticut law to determine whether such a clause was enforceable.\textsuperscript{199} In Connecticut, liquidated damage clauses are upheld if "(1) at time the contract was made, damages expected . . . were uncertain in amount or difficult to prove; (2) the parties intended to liquidate damages in advance; and (3) the amount stipulated was 'reasonable.'\textsuperscript{200} If the termination fee provision could not meet this requirement, it was dead. Judge Kenner, however, went on to note that Section 506(b) limits secured party recoveries to "reasonable" fees, costs, or charges.\textsuperscript{201} Courts have taken this to mean \textit{actual} expenses.\textsuperscript{202}

\textsuperscript{194} Bratton, supra note 192, at 398.
\textsuperscript{195} See supra note 192.
\textsuperscript{198} \textit{Id.} at 749-50.
\textsuperscript{199} \textit{Id.} at 750.
\textsuperscript{200} \textit{Id.}
\textsuperscript{201} \textit{Id.}
\textsuperscript{202} \textit{See, e.g., In re Kroh Bros. Dev. Co.}, 88 Bankr. 997, 1001 (Bankr. W.D. Mo. 1988) (applying a liquidation damages standard to a prepayment premium); \textit{In re Lane Poultry}, 63 Bankr. 745, 749 (Bankr. M.D.N.C. 1986); see also \textit{In re Baker}, 49 Bankr. 240, 242-43 (Bankr. E.D. Pa. 1985) (a contract clause setting attorneys' fees as a percentage of the principal indebtedness, although valid under state law, will be allowed under \$ 506(b) only to the extent that there is evidence of the need for, and value of, the services provided).
Judge Kenner reasoned:

[A]lthough a liquidated damages charge may be reasonable and valid under Connecticut law because it was a reasonable estimate of the damages anticipated when the contract was made, that same charge will be valid and enforceable under § 506(b) only to the extent that the secured party actually incurred damages.\textsuperscript{203}

In the end, by limiting recovery to actual expenses incurred, the court radically transformed the nature of this termination fee. If the secured party was entitled to those expenses under the contract, then the termination fee clause added nothing to the secured party’s rights. But if the secured party had no right to collection expenses, then the termination fee set the upward limit on how much collection expense the secured party could collect from the collateral.\textsuperscript{304}

One interesting construction of a loan agreement went as follows: the contract called for a four percent lump sum payment for any installment payment that is late, but because the secured party accelerated the loan, it rendered the ability of the debtor to pay installments impossible.\textsuperscript{106}

Hence, the penalty was excused.\textsuperscript{206} This was so even though a stipulation between the secured party and the trustee reinstated the right to pay in-

\textsuperscript{203} In re Morse Tool, Inc., 87 Bankr. at 750.

\textsuperscript{304} Id.; see In re LHD Realty Corp., 20 Bankr. 722, 725 (Bankr. S.D. Ind. 1982) (court deemed 4% surcharge on late payment that was actually made to be reimbursement for actual expenses, but found that 4% charge on payments that were never made to be void as a penalty), aff’d, 726 F.2d 327 (7th Cir. 1984).

As a variation on this theme, some courts have held that even though only actual damages can be recovered (in spite of the prepayment penalty clause), “actual damages” include the difference between the higher market rate and the lower contract rate. See, e.g., Imperial Coronado Partners, Ltd. v. Home Fed. Sav. & Loan Ass’n (In re Imperial Coronado Partners, Ltd.), 96 Bankr. 997, 1001 (Bankr. 9th Cir. 1989). An issue has arisen with regard to calculation of those damages. In two cases, the contract provided that damages would be total interest dollars due under the contract rate minus total dollars that would be obtained if principal were invested in risk-free, short-term treasury notes, and this amount was not to be discounted to present value. In re Kroh Bros. Dev. Co., 88 Bankr. 997, 998-1002 (Bankr. W.D. Mo. 1988); In re Skyler Ridge, 80 Bankr. 500, 503 (Bankr. C.D. Cal. 1987) (applying liquidated damage standards to a prepayment premium because parties stipulated to that standard, in spite of uncertainty as to whether it was appropriate). Both courts struck down the prepayment clause as unreasonable: first, the “risky” contract rate should have been compared to some rate of comparable risk; and second, there should have been a discount to present value. In re Kroh Bros Dev. Co., 88 Bankr. at 998-1002; In re Skyler Ridge, 80 Bankr. at 503. For the view that the Kroh court was guilty of “fine tuning,” see Fisher, supra note 174, at 22-23.


\textsuperscript{206} Id. at 141.
stallments. Judge Conrad reasoned that the stipulation did not also re-
install the penalty, and there was no justification for importing a penalty
from one agreement into another separate agreement.

D. High Postdefault Interest Rates

Loan agreements commonly provide that after default, interest rates
are to be higher. These high postdefault interest rates are often allowed
under state law.

As stated earlier, the meaning of Ron Pair is that the contract does
not govern the oversecured party’s entitlement to postpetition interest.
Accordingly, just because the contract requires an increased interest rate
after default does not mean that a bankruptcy court must honor this con-
tract in bankruptcy. On the other hand, the contract does govern “fees,
costs, and charges.” Therefore, if the extra interest can be called a “fee,
cost, or charge” to compensate for default, the contract might yet still gov-
ern. These clauses, however, are not characterized this way. Usually, they
are defended as compensation for extra risk of an insolvent debtor. Yet
this is precisely the traditional role for a basic interest rate as well. Hence,
it is not clear that higher postdefault interest rates can survive Ron Pair.

In addition, some courts have ruled that higher postdefault interest
rates are not subject to a “reasonableness” requirement. Instead, “[a] court
should allow contractually bargained for default interest rates under
Section 506(b) without examining the reasonableness of these rates pro-
vided they fall within the range of acceptable rates.” Such a view
clearly associates higher default rates with interest, rather than contrac-

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807 Id. at 140-41.
808 Id. at 141-42.
809 See The Bank of Last Resort, supra note 138, at 264-65. But see Garrett v. Coast & Sou-
810 See supra notes 14-23 and accompanying text.
811 See In re 433 South Beverly Drive, 117 Bankr. 563, 565-67 (Bankr. C.D. Cal. 1990). In
Beverly Drive, Judge Lax noted that higher default interest rates could be avoided generally because
Cure and disimpairment are discussed supra in the text accompanying notes 67-86.
812 See, e.g., Ruskin v. Griffiths, 269 F.2d 827, 832 (2d Cir. 1959), cert. denied, 361 U.S. 947
(1960).
813 See, e.g., Connecticut Gen. Life Ins. Co. v. Schaumberg Hotel Owner, L.P. (In re
Schaumberg Hotel Owner, L.P.), 97 Bankr. 943, 951 (Bankr. N.D. Ill. 1989); see In re Skyler Ridge,
80 Bankr. 500, 511 (Bankr. C.D. Cal. 1987) (“Any restriction on the contract rate of interest must
thus come from state law, and not from bankruptcy law.”).
814 In re Schaumberg Hotel Owner, 97 Bankr. at 951.
tuial “fees, costs, and charges.” In turn, *Ron Pair* disenfranchises the contract together with the concept of higher postdefault interest rates.\(^{215}\)

Some courts do purport to review higher postdefault interest rates for reasonableness.\(^{216}\) Other authorities specify that higher postdefault interest rates have to pass muster under the liquidated damage clause tests, just the same as flat payment penalties are tested.\(^{217}\) These opinions are more consistent with the idea that higher postdefault interest rates are in the nature of a “fee, cost, or charge” within the meaning of Section 506(b). As such, the contract *does* govern, and the contract rate, therefore, might be applied.

Even if the contract is made relevant by this move, it must, of course, be reasonable under a federal and perhaps a state standard. A few pre-*Pair* courts refused to allow the increase in interest rate after default (unless the debtor is solvent), noting that, after default, there is little risk of nonpayment given that the debtor is under the supervision of a bankruptcy court.\(^ {218}\) One court read a loan agreement to mean that the higher

\(^{215}\) Pre-*Pair* courts sometimes reasoned that the higher postdefault rate results in a lower predefault rate, and, therefore, should be upheld. See, e.g., *Ruskin*, 269 F.2d at 832; *In re Berry Estates, Inc.*, 34 Bankr. 612, 615-16 (Bankr. S.D.N.Y. 1983); see also *Baylor, After Bankruptcy Lets the Curtain Fall: Are Claims in Reorganization Proceedings for Post-Petition Interest at Higher "Default Rates" Consigned to Universal Darkness?*, 86 COM. L.J. 221 (1981) (arguing for freedom of contract). This argument, however, should also suffice for prepayment penalties—or any overreaching advantage for secured parties, such as torture or kidnapping.

The *Berry Estates* court, nevertheless, improvised on the contract, which had called for a specified postdefault rate or the maximum rate allowed by law, whichever was higher. *In re Berry Estates, Inc.*, 34 Bankr. at 614-15. Subsequently, the New York legislature repealed the relevant usury limitations, meaning that the lender seemed entitled to *infinite* interest. *Id.* at 615. The court intervened and awarded the lender what it took to be a market rate of interest. *Id.* at 616.


In *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946), a debenture provided for interest on unpaid interest. *Id.* at 157-58. This contract was valid under state law, but it was struck down for being unreasonable or for being a penalty. *Id.* at 164. The *Vanston* opinion continues to be much cited today.

Although *Vanston* deals with interest on interest, Judge Waterman thought *Vanston* might also apply to higher default rates as well, but that *Vanston* should *not* apply when the debtor is solvent. *Ruskin v. Griffiths*, 269 F.2d 827, 830-32 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960).


rate became applicable only if the secured party declared a default. The secured party had not declared a default before bankruptcy, and to do so after bankruptcy would have violated the automatic stay. Also, the fact that bankruptcy itself was an event of default was declared to be unenforceable, and therefore, the effectiveness of the higher interest rate was blocked. These opinions might still cancel the contract even if Ron Pair does not.

Even if the postdefault interest rate is valid, the rate can be avoided if the debtor-in-possession decides to decelerate the loan under Bankruptcy Code Section 1124(2). According to Section 1124(2), “notwithstanding any contractual provision . . . that entitles the [creditor] to demand or receive accelerated payment . . . after the occurrence of a default,” the debtor-in-possession can reinstate the maturity of the loan if all past defaults are cured and damages paid. This provision is similar to the “executory contracts” provision of the Bankruptcy Code, which permits the debtor-in-possession or trustee to capture the value that such prospective obligations might hold.

One creditor entitled to a higher postdefault interest rate tried to save this privilege by arguing that Section 1124(2) applies only to accelerated loans—that is, loans the secured party chose to accelerate. Since it had a fully mature claim, which it had not accelerated, the creditor argued that it should be able to insist on full payment of the higher postdefault interest rate. The Ninth Circuit rejected this argument. Even here, deceleration under Section 1124(2) allows the debtor-in-possession to escape the postdefault interest rate. That is, Section 1124(2) allows for the allocation of the status quo as if no default occurred, which has the magical effect of lowering the interest rate to predefault levels.

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220 Id. at 386.
221 For a discussion of deceleration, see supra notes 67-86 and accompanying text.
222 See Florida Partners Corp. v. Southeast Co. (In re Southeast Co.), 868 F.2d 335 (9th Cir. 1989); In re Singer Island Hotel, Ltd., 95 Bankr. 845 (Bankr. S.D. Fla. 1989).
225 Great Western Bank & Trust v. Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.), 850 F.2d 1338, 1342-44 (9th Cir. 1988). In this case, “cure” meant paying the secured party in full.
226 Id.
227 Id.
228 For an opinion that invalidates high postdefault rates generally because cure and deceleration are hypothetically possible under Chapter 11, see In re 433 South Beverly Drive, 117 Bankr. 563.
E. Interest on Interest

Suppose interest payments are in default. Can an oversecured party obtain interest on interest under Section 506(b)?

Outside bankruptcy, some states flatly disallow it. Others allow it if it is in the contract. Yet, as earlier discussion has indicated, the Supreme Court in *United States v. Ron Pair Enterprises, Inc.* has ruled that the right of a secured party to postpetition interest is not necessarily governed by the contract, or even state law. Rather, the contract governs only “costs, fees, and charges.” Therefore, whatever rights a secured party has to interest on interest, she has them irrespective of the contract, unless they can be characterized as a “cost, fee, or charge.”

If *Ron Pair* stands against the use of the contract for determining whether interest on interest should be allowed, the still—respected decision in *Vanston Bondholders Protective Committee v. Green* disallows it as a matter of federal equity. In that reorganization case, the contract called for interest on interest in case payments were late. New York law disallowed interest on interest, but the Supreme Court ruled that, as a matter of federal law, the contract provision was void as a penalty.

This prejudice against interest on interest can be questioned for at least three reasons. First, interest on interest can be viewed as purely compensatory. That is, a debtor has defaulted on an interest payment, and the creditor is deprived of funds for a period of time. Interest is the traditional remedy for depriving a creditor of funds. What difference does it make that the amount due was itself an interest obligation?

Second, interest on interest may be required in order to cure past

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109 S. Ct. 1026 (1989); see supra text accompanying notes 14-23.

Recall that § 506(b) gives oversecured parties “interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement.” The Supreme Court thought that the comma after “claim” proved that the contract does not govern the interest entitlement of oversecured parties. See supra note 21 and accompanying text.

329 U.S. 156 (1946); see supra note 24 and accompanying text.

Id. at 157-58.

Id. at 164. *Vanston* was followed to disallow interest on interest under Section 506(b) in *In re Laymon,* 117 Bankr. 563, 564 (Bankr. W.D. Tex. 1990).

See L. JONES, MORTGAGES § 650, at 1076 (5th ed. 1908).
defaults and disimpe a secured party. This rule reflects the compensatory nature of interest on interest. If interest on interest is required, or at least allowed as part of a cure, why should it not be used routinely under Section 506(b) whenever postpetition interest is accrued, instead of paid out?

Third, as with the distinction between lump sum payments and higher postdefault interest, interest on interest does not seem distinguishable from the default penalties, which are allowed if they qualify under state liquidated damage standards. Every such lump sum payment is to some degree interest on interest. That is, if an installment payment partly represents interest, a lump sum percentage penalty on a late installment could easily be characterized (and must be characterized) as compensatory payment to the lender for the lateness of the payment; this is nothing but interest on interest. Nevertheless, whereas lump sum penalties are accepted as a form of liquidated damages, interest on interest seems to set off alarm bells.

The court in Shearson Lehman Mortgage Corp. v. Laguna (In re Laguna) managed to dodge the implication of Ron Pair by pointing

\[\text{Note:} \quad \text{See supra notes 210-227 and accompanying text.}\]
out that California law specifically disallows interest on interest unless the contract provides for it. In other words, Section 506(b) presupposes that state law requires interest payments, and if California requires a contract, then Ron Pair is supposedly superseded—a contract there must be.

This argument, of course, presupposes that even if the contract (as abstracted from state law) does not govern interest, state law (as abstracted from contract law) does. Yet Ron Pair can easily be read to mean that federal law is to govern the rate of interest. This is indeed what the Vanston court explicitly said, and there is no evidence that this well-known opinion was intended to be overruled by the drafters.

V. Conclusion

This article has tried to describe in a comprehensive way the rights of an oversecured creditor under Bankruptcy Code Section 506(b). It has tried to show the implications of a rule that makes the equity cushion the limit of Section 506(b) entitlements to interest and collection expenses. Specifically, this article has tried to reconcile the contradiction between this idea and the idea of cash payments as a means of adequate protection.

In addition, this article has examined the implications of Ron Pair, which holds that the contract does not govern the rate of interest, although it does govern collection expenses, late charges, and the like. The chief casualty in this analysis was higher default interest rates. Because the contract is disenfranchised from interest rates, postdefault rates can be justified only if they can be deemed "fees, costs, and charges," which Section 506(b) does subject to the contract. Finally, interest on interest has been barred by a pre-Code Supreme Court, but in light of recent doctrine involving "disimpairment," where interest on interest is allowed, this policy might now be reconsidered.

\[\text{Id. at 216.}\]
\[\text{Id. at 217.}\]
\[\text{As was done by Judge Clark in In re Laymon, 117 Bankr. 856 (Bankr. W.D. Tex. 1990).}\]
\[\text{Laguna also addressed a purely real estate concern. Under Chapter 13, the plan may not "modify" the rights of a mortgagee claiming the debtor's principal residence as collateral. 11 U.S.C. § 1322(b)(2) (1988). Laguna and other cases reason that giving interest on interest in the absence of a contractual agreement constitutes an illegal modification (in the mortgagee's favor). 113 Bankr. at 216-18; see In re Capps, 836 F.2d 773 (3d Cir. 1987) (no interest on interest as part of cure where the contract does not call for it); Foster Mortgage Co. v. Terry (In re Terry), 780 F.2d 894 (11th Cir. 1985).}\]