In the Interest of Fairness: Interest Payments in Bankruptcy

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I. INTRODUCTION

Bankruptcy is seldom a panacea for any party entangled in the process. For debtors, bankruptcy is usually a last resort. The financial probing and disclosure surrounding the process and the humiliation that may accompany the filing of a petition make bankruptcy an unattractive alternative. For creditors, bankruptcy usually indicates that serious financial difficulties have overcome the debtor, meaning that
the creditor may get little of the money it is owed. Also, the delay that is a part of bankruptcy is a distressing fact of life for all creditors.1 Creditors may wait years for a bankruptcy to move from petition to confirmation2 just to be told that they must wait another ten years to be paid off under a plan, or worse yet, that they will not be paid at all.

Creditors traditionally have charged interest as compensation for the delay they face as debtors repay money owed. Therefore, the burden caused by the delay of bankruptcy could be alleviated if creditors would receive interest on their claims while the bankruptcy is proceeding. While not generous, the Bankruptcy Code (the “Code”) allows a select group of creditors to recover interest for the delay in receiving payment of a claim.3 The purpose of this comment is to outline those delays which are compensable with interest, those creditors that can collect interest, and how much interest such creditors can expect to receive.

For purposes of this comment, the bankruptcy process will be divided into three distinct time periods. The first period is the time before and immediately preceding the bankruptcy.4 This period will be called the pre-petition period. The time frame from the filing of a petition until the confirmation of a plan5 will be called the gap period. Finally, the time after the confirmation of the plan will be called the post-confirmation period.

II. PRE-PETITION PERIOD

The Code allows a creditor to assert claims for pre-petition interest. To the extent that a creditor has a claim for pre-petition matured interest, a bankruptcy court will allow interest to be included as a part of a claim under Section 502 of the Code.6 The amount of pre-petition interest allowed is that amount which has actually accrued prior to the

1. Chapter 12 cases move rapidly through the bankruptcy court, theoretically in 135 days. See 11 U.S.C.A. §§ 1221, 1224 (West Supp. 1988). However, it is not uncommon for Chapter 11 cases to be pending in a bankruptcy court for several years. For creditors with large claims against the debtor, interest costs alone can amount to thousands of dollars during the pendency of the claim.
2. This paper will focus only on Chapters 11, 12, and 13 of the Bankruptcy Code. Chapter 7 liquidations and Chapter 9 municipal reorganizations will not be discussed at any length.
4. A bankruptcy is commenced by the filing of a petition with the bankruptcy court. 11 U.S.C. § 301 (1982).
5. Confirmation of the plan refers to court approval of a plan of reorganization or repayment under Sections 1129, 1225, or 1325.
6. Section 502 allows claims of a creditor for interest except to the extent that the claim is for unmatured interest. 11 U.S.C. § 502(b)(2) (1985). Claims for matured interest are, therefore, impliedly allowed.
filing of the petition. For example, a claim on a $1,000 note issued one day before bankruptcy would be allowed only to the extent of the cash actually advanced. If the original discount on the note was ten percent, so that the cash advance was $900, then only a $900 claim would be allowed, not the $1,000 face value of the note. If the note was one year old, the interest component of the note would have to be prorated and interest would be allowed for the one-year period before the filing of the petition. In summary, all creditors are allowed to receive matured pre-petition interest as allowed under an agreement with the debtor.

III. INTEREST DURING THE GAP PERIOD

A. Section 506(a)—Valuation and Timing

In 1978, Congress passed the Bankruptcy Reform Act of 1978. A significant change made by the Code in the former law is the treatment of secured creditors and secured claims under Section 506. Unlike the pre-Code law, Section 506 distinguishes between secured and unsecured claims rather than between secured and unsecured creditors. Subsection (a) of Section 506 provides that an allowed claim of a creditor secured by a lien on property in which the estate has an interest, is a secured claim only to the extent of the value of the creditor's interest in the estate's interest in the property. The creditor's claim is an unsecured claim to the extent that the value of the creditor's interest in the property is less than the amount of the allowed claim. Therefore, Section 506 divides a creditor's claim into two parts. A creditor has a secured claim to the extent of the value of its interest in the collateral securing its claim and an unsecured claim for the balance of the allowed claim. For example, if a creditor has an Article 9 security interest in a combine valued at $10,000 securing an allowed claim of $15,000, the creditor will have a secured claim of $10,000 and an unsecured claim of $5,000. Such a creditor would be recognized as being undersecured. If the combine was worth $15,000 and the creditor's allowed claim was $10,000, the creditor would have a secured claim for $10,000 and would be oversecured.
Bifurcation of claims is important because once a creditor is determined to have a secured claim, it is entitled to adequate protection; and, if the creditor is oversecured, the creditor may be allowed interest during the administration of the case.

The Section 506 determination of secured status applies to a wide variety of claims in addition to mortgages and security interests under Article 9. "Lien" as used in Section 506(a) is defined to mean a "charge against or interest in property to secure payment of a debt or performance of an obligation." Therefore, the secured status of statutory liens, like judicial and mechanics liens, are within the scope of Section 506(a).

When a court determines the creditor's secured status under Section 506(a), the collateral securing the claim must be valued "in light of the purpose of the valuation and of the proposed disposition or use of such property." The value is to be determined on a case-by-case basis, taking into account the facts and competing interests in each case. A Section 506 valuation is binding only for the purposes for which the determination is made and may change later when other valuations are required.

A variety of valuation standards exist and have been used by the courts. Value does not necessarily imply forced sale or liquidation value. For example, courts use fair market value, retail value, or going concern value, especially in Chapter 11, 12, or 13 cases where the debtor intends to retain the property. Even after the standard to be

creditor's claim is called an "equity cushion." 11 U.S.C. § 1111(b) (1982) contains an important exception to the bifurcation of an allowed claim as secured and unsecured. Section 1111(b) allows a creditor to opt out of the consequences of Section 506(a) and have the entire amount owing to the creditor treated as if it were a totally secured claim and thereby obtain a benefit of anticipated future increases in the value of the collateral. However, a creditor electing 1111(b) treatment gives up the right to any unsecured claim. Therefore, an inadequately collateralized secured creditor who otherwise would have a secured claim equal only to the value of its collateral, will be deemed to have a secured claim equal to the full amount of its claim, but will be precluded from having any unsecured deficiency claim. Pachulski, The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code, 58 N.C.L. REV. 925, 933 (1980).

17. See infra notes 37-103 and accompanying text.
23. See, e.g., In re Robinson Ranch, Inc., 75 Bankr. 606 (Bankr. D. Mont. 1987)(fair market value used in Chapter 12 rather than liquidation value); In re Fiberglass
used is determined, there are often several ways to arrive at different values using the same standard.\textsuperscript{24} Usually, a court is presented with several values and/or standards in order to arrive at a reasonable and fair valuation.

The time when collateral is valued also is important because value may fluctuate considerably in a short period of time.\textsuperscript{25} Therefore, a creditor may have a fully secured claim at one valuation date and be undersecured six months later.\textsuperscript{26} However, Section 506 does not specify the time at which the valuation is to be made. Some courts have held that the property should be valued as it existed at the time of the filing of the petition.\textsuperscript{27} Other courts have held that the collateral should be valued at or near the hearing date to determine Section 506 secured status.\textsuperscript{28} In \textit{United States v. Booth Tow Services},\textsuperscript{29} the court reasoned that the collateral should be valued as of the hearing date because Section 506(a) provides that the proper time to value the secured status of a creditor is “in conjunction with [the] hearing on [the] disposition” of the property.\textsuperscript{30} The \textit{Booth} date is more sensible because it is based on Section 506. Also, valuation as of the petition date may be difficult if the case is one or two years-old and the appraisal was not done on the filing date.

Rule 3012\textsuperscript{31} allows any party to protect its interest by filing a motion to have the secured status of a claim determined. Therefore, valuing the property on the hearing date will reward diligence of a creditor or debtor. If the collateral is declining in value as of the petition date, a creditor can file a motion for a Section 506 secured status determination immediately and thereby maximize the amount of its secured claim. Conversely, if the collateral is appreciating, the debtor can get a Section 506 determination of secured status and preserve the increasing value of the asset for other creditors, or the estate. When the

\textsuperscript{24} See, e.g., \textit{In re Holtz}, No. BK84-2434, slip op. at 1 (Bankr. D. Neb. Nov. 18, 1984)(appraisers use market approach, cost approach, and income approach to estimate fair market value of farmland).

\textsuperscript{25} The precipitous drop in values of farmland in Nebraska in the early 1980s illustrates how severely some collateral can fluctuate in value.

\textsuperscript{26} Creditors usually want to have their claim fully secured. This will increase the probability they will be paid in full under a plan and it entitles the creditor to adequate protection of its entire interest.

\textsuperscript{27} See, e.g., \textit{Fox v. Peck Iron & Metal Co.}, 25 Bankr. 674, 697 (Bankr. S.D. Cal. 1982)(no reasoning provided); \textit{In re Adams}, 2 Bankr. 313, 314 (Bankr. M.D. Fla. 1980)(begging the question by reasoning that petition date is a time when creditor's rights are fixed).

\textsuperscript{28} \textit{In re Klien}, 10 Bankr. 657, 661 (Bankr. E.D.N.Y. 1981); \textit{In re Jones}, 5 Bankr. 735, 739 (Bankr. E.D. Va. 1980).

\textsuperscript{29} 64 Bankr. 539 (Bankr. W.D. Mo. 1985).

\textsuperscript{30} \textit{id.} at 542 (quoting 11 U.S.C. § 506(a) (1985)).

valuation is determined as of the hearing date, no party is forced to accept an adverse value unless it is remiss. The standard and timing of the valuation can be very important to creditors with secured claims because each can determine whether the creditor will get interest in the gap period.

B. General Prohibition on Interest During the Case

The general rule in bankruptcy is that interest ceases to accrue on secured and unsecured claims with the filing of the bankruptcy petition.\(^{32}\) Section 502(b)(2) codifies the common law prohibition on the payment of interest after the case is commenced.\(^{33}\) Interest is prohibited during the gap period because it is seen as a penalty on the debtor for the delay caused by the proceedings.\(^{34}\)

Three exceptions have been developed by courts to allow secured creditors to get interest on their claim during the gap period.\(^{35}\) Interest has been allowed on claims (1) where the debtor ultimately proves to be solvent; (2) where the security held by the creditor as collateral produces income after the filing of the petition; and (3) where the security is sufficient to pay the interest, as well as the principal amount of the claim.\(^{36}\)

C. Section 506(b)—The Joys of Having an Oversecured Claim

Section 506(b) of the Code 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 under the agreement under which such claim arose.\(^{37}\)

Section 506(b) has been interpreted to be a codification of the third exception to the general prohibition against allowing interest during the gap period.\(^{38}\) Simply put, a creditor with an oversecured claim can recover interest on its claim in the gap period to the extent that the

36. In re Boston & Main Corp., 719 F.2d 493, 496 (1st Cir. 1983); In re Walsh Constr., Inc., 669 F.2d 1235, 1230 (9th Cir. 1982); In re Kerber Packing Co., 276 F.2d 245, 246 (7th Cir. 1960); United States v. Bass, 271 F.2d 129, 130 (9th Cir. 1959); In re Macomb Trailer Co., Inc., 303 F.2d 611, 613 (6th Cir. 1962), cert. denied, 345 U.S. 958 (1953).
38. Curious Comma, supra note 35, at 278.
value of the collateral exceeds the amount of the allowed claim. Consequently, if a combine valued at $15,000 secures a claim of $10,000, the creditor can recover up to $5,000 in gap period interest from the equity cushion. While the creditor will be subject to the delay of bankruptcy, the delay is more tolerable when the interest clock is running. Section 506(b) gives oversecured creditors an increasing lien as interest costs increase, with the same priority as the underlying claim. The allowed secured claim is increased as interest accrues, and the total amount of the claim is entitled adequate protection. The interest continues to be part of the allowed secured claim until the principal and interest exceed the value of the collateral. At that point, accruing interest becomes an unsecured claim.

The reality of Section 506(b) is that, if a creditor has an unsecured claim or undersecured claim, no interest can be recovered during the gap period. "[T]he undersecured creditor, who has no such [equity] cushion, falls within the general rule disallowing postpetition interest." Several courts of appeal attempted to provide undersecured creditors with gap period interest despite Section 502(b)(2). In In re American Mariner Industries, the Ninth Circuit held that an undersecured creditor is entitled, as a matter of law, "to compensation for the delay in enforcing its rights" against its collateral during the proceedings. American Mariner held that monthly interest payments at a market rate on the liquidation value of the collateral securing the claim must be made to the undersecured creditors. The court based its decision on Sections 361 and 362 of the Code, stating that the concept of adequate protection required monthly payments to undersecured creditors.

In In re Briggs Transportation Co., the Eighth Circuit found that Section 502(b) did not preclude compensation to undersecured credi-

39. See supra note 8.
40. It is unlikely that such a creditor can get relief from the automatic stay under Section 362 where a $5,000 equity cushion exists.
43. Id. at 631 (citing 11 U.S.C. § 502(b)(2) (1985)).
44. See In re Timbers of Inwood Forest Assoc., 793 F.2d 1380 (5th Cir. 1986), aff'd, 108 S. Ct. 626 (1988); In re Briggs Transp. Co., 780 F.2d 1339, (8th Cir. 1985); Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985); In re American Mariner Indus., 734 F.2d 426 (9th Cir. 1984).
45. 734 F.2d 426 (9th Cir. 1984).
46. Id. at 435.
47. Id.
48. Section 502(b) was not mentioned in American Mariner.
49. 780 F.2d 1339 (8th Cir. 1985).
tors for the delays of bankruptcy. The court held that the bankruptcy court has the discretion to allow interest payments to undersecured creditors. The facts of each case, such as the nature of the collateral, whether it is appreciating or depreciating in value, the length of the stay, and whether the collateral is being kept free of statutory liens determine whether an undersecured creditor is entitled to gap period interest.

The Supreme Court recently addressed the question of whether an undersecured creditor is entitled to interest during the gap period because of the delay caused by the automatic stay. In *United Savings Association v. Timbers of Inwood Forest Associates*, the Court used a multiple code section analysis to conclude that undersecured creditors are not entitled to interest payments during the gap period. The Court first held that undersecured creditors fall within the Section 502(b) prohibition on post-petition interest. Additionally, the careful wording of Section 506(b) to allow interest only on oversecured claims was strong evidence against undersecured interest seekers. Finally, the Court found that the *American Mariner* rationale based on Section 362(d)(1) effectively gutted Section 362(d)(2) of meaning.

Based upon Sections 502, 506, and *Timbers*, undersecured creditors clearly are not entitled to obtain interest payments during the gap period for the delays caused by the automatic stay. However, oversecured creditors can get interest payments on their claims during the gap period. Probably.

D. Consensual v. Nonconsensual—Are You a Mortgagee or a Judgment Creditor?

During the pre-Code development of exceptions to the general prohibition on gap period interest, questions arose as to whether all oversecured creditors could recover interest. Five courts of appeal held that pre-Code law did not allow the payment of gap period interest on oversecured tax claims. All courts conceded that oversecured consensual liens were entitled to interest during the gap period, but dis-

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50. *Id.* at 1347.
51. *Id.* at 1349.
53. *Id.* at 631.
54. *Id.*
55. *Id.* at 632.
56. That is not to say, however, that undersecured creditors are limited in getting payments for adequate protection under Sections 361 and 362 if the value of the collateral is depreciating. *Id.* at 629-30.
57. See *In re Boston & Maine Corp.*, 719 F.2d 493 (1st Cir. 1983); *In re Kerber Packing Co.*, 276 F.2d 245 (7th Cir. 1960); *United States v. Bass*, 271 F.2d 129 (9th Cir. 1959); *United States v. Harrington*, 269 F.2d 719 (4th Cir. 1959); *United States v. Mighell*, 273 F.2d 682 (10th Cir. 1959).
tungished nonconsensual liens for purposes of obtaining interest. The basis for the distinction was that a contractual lien, such as a mortgage or Article 9 security interest, is a bargained for consensual undertaking where the parties contemplate the payment of interest. Giving gap period interest to oversecured consensual claimholders was seen as necessary to satisfy the expectations of the parties and to strike a balance between creditors and debtors. However, nonconsensual oversecured claimholders were denied gap period interest because those creditors did not bargain for interest. The rationale was that such creditors never contemplated receiving interest, did not deserve interest, and the allowance of interest would penalize lower priority creditors.

Accordingly, there was created a fairly uniform rule that oversecured consensual claims were allowed to accrue gap period interest, but oversecured nonconsensual claims were not. Because statutory liens, including mechanics, fertilizer, tax, and judgment liens, are generally nonconsensual in nature, the rule can have a significant impact on those creditors who rely on such liens and the availability of recovering interest on claims secured by nonconsensual liens. With the passage of Section 506(b), courts have again raised the consensual versus nonconsensual distinction.

E. Section 506(b)—Do I Need a Consensual Lien?

Contrasting decisions have been reached on the question of whether Section 506(b) allows for recovery of gap period interest on oversecured nonconsensual claims—claims usually given lien status by state statute. One line of cases hold that Section 506(b) authorizes the allowance of gap period interest to all oversecured creditors, regardless of whether the creditor's lien is consensual or nonconsensual in nature. However, a nearly equal number of courts have concluded that gap period interest is not allowed on oversecured nonconsensual claims.

58. Curious Comma, supra note 35, at 279.
60. Id.
61. While most statutory liens do not include a specific authorization to recover interest, some do. For example Neb. Rev. Stat. § 45-104.01 (1984) and Neb. Rev. Stat. § 77-207 (1986) authorize the State of Nebraska to assess interest at fourteen percent on delinquent real estate taxes. The question is whether this statutory right is enforceable in bankruptcy.
63. See, e.g., In re Ron Pair Enters., 828 F.2d 367 (6th Cir. 1987)(tax lien); In re New-
The Sixth Circuit recently addressed the question of whether Section 506(b) authorizes the payment of gap period interest on an oversecured claim when the claim is nonconsensual in nature in *In re Ron Pair Enterprises*. In *Ron Pair*, the United States claimed that it was entitled to gap period interest on oversecured claims for withholding and social security taxes. The debtor argued that the language of Section 506(b) “provided for under the agreement under which such claim arose,” modifies “interest on such claim.” Therefore, the debtor argued that Section 506(b) codifies the judicially created pre-Code rule disallowing interest on nonconsensual claims, because an agreement did not provide for interest on the tax claims. The debtor also asserted that the language of Section 506(b) is too ambiguous to infer a congressional intent to deviate from the pre-Code rule.

The government claimed that Section 506(b) clearly allowed interest on all oversecured claims because the “phrase ‘interest on such claim’ is set off by commas and is followed by the words ‘and any,’ indicating that interest is to be treated differently than fees, costs or charges” under Section 506(b). The government proposed that Section 506(b) was unambiguous and that pre-Code law was no longer relevant.

The court held that interest is not authorized for nonconsensual oversecured claims because Section 506(b) does not clearly overrule the pre-Code rule. The court considered pre-Code law relevant, because “the language of a statute is always the starting point when its construction is at issue, [but] it is only the starting point.” After an extensive review of the pre-Code law, the court concluded that “the language of section 506(b), when read in light of the pre-Code judicially created doctrine, codifies the pre-Code law on the issue of allowable postpetition interest.” This conclusion was based on “[t]he normal rule of statutory construction . . . that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications.”

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64. 828 F.2d 367 (6th Cir. 1987).
65. 11 U.S.C. § 506(b) (1985). For the full text of section 506(b), see text accompanying note 37.
67. *Id.*
68. *Id.*
69. *Id.* at 368.
70. *Id.* at 369-70 (citations omitted).
71. *Id.* at 372.
While the court never stated that Section 506(b) was ambiguous, the court did not find Section 506(b) unambiguous enough to change the pre-Code rule.73

Bankruptcy courts also have found that Section 506(b) does not authorize interest payments on oversecured nonconsensual claims.74 Most of the courts have found that Section 506(b) expressly provides that interest can only be granted pursuant to an agreement, or that Section 506(b) is ambiguous and should only be construed to be a codification of pre-Code law. For example, in In re Newbury Cafe, Inc.,75 the court found the pre-Code rule too strong to be overruled by the ambiguous Section 506(b), even though the two districts in Massachusetts now have different constructions of Section 506(b).76

Commentators also have agreed that Section 506(b) is too ambiguous to change the pre-Code rule.77 Collier states that, even if a creditor is oversecured, without a contractual agreement, post-petition interest is not allowable under Section 506(b).78 Collier also explains that the comma placement in Section 506(b) was not to allow interest on nonconsensual claims, but to prevent a reading where interest not only would be allowed on the underlying claim, but also on fees, costs, and charges.79

F. All Oversecured Claims Get Interest in Some Courts

While many courts read Section 506(b) to codify the pre-Code rule that gap period interest is not allowed on oversecured nonconsensual claims, substantial authority exists to support a claim for such interest.80 In In re Best Repair Co.,81 the United States was once again trying to get gap period interest on an oversecured tax claim. The Fourth Circuit Court of Appeals found that the plain and natural reading of the statute allowed gap period interest under Section 506(b). The court found that the placement of the comma was intended to separate the ability to get gap period interest on a claim, from any requirement

73. In fact, the court stated that pre-Code law should be used to show that the Code is ambiguous. Id. at 373.
76. The court in In re Russo, 63 Bankr. 335 (Bankr. D. Mass. 1985)(now the western district bankruptcy court) allowed interest on oversecured nonconsensual claims.
77. See Curious Comma, supra note 35, at 284-86. For a discussion that at least prepetition tax claims secured by a valid tax lien are not entitled to gap period interest, see Bancroft, Postpetition Interest on Tax Liens in Bankruptcy Proceedings, 62 AM. BANKR. L.J. 327 (1988).
78. COLLIER, COLLIER ON BANKRUPTCY ¶ 506.05, at 506-41 (15th ed. 1988).
79. Id. at 506-43.
80. See supra note 63.
81. 789 F.2d 1080 (4th Cir. 1986).
that there be an agreement providing for interest.\textsuperscript{82} While the \textit{Best Repair} court ignored the pre-Code rule, another bench of the Fourth Circuit has interpreted \textit{Best Repair} to find that Section 506(b) made a change in the pre-Code substantive law.\textsuperscript{83}

Bankruptcy courts also have supported the result reached in \textit{Best Repair} for a variety of nonconsensual claims.\textsuperscript{84} The issue has been limited to the circuit, district, and bankruptcy courts. The Supreme Court has not yet clarified the divided construction of Section 506(b). In \textit{United Savings Association v. Timbers of Inwood Forest Associates},\textsuperscript{85} on an unrelated issue, the Court stated, without qualification, that oversecured creditors are entitled to interest under Section 506(b) to the extent of the "security cushion."\textsuperscript{86} However, the Court also stated that Section 506(b) merely codified pre-Code law which denied undersecured creditors gap period interest.\textsuperscript{87} Therefore, it is difficult to predict whether the Court would allow gap period interest to all oversecured creditors or whether it would find the pre-Code law controlling. Due to the split that currently exists in the lower federal courts, the Supreme Court may give a definitive answer soon.

G. \textbf{How Much Interest Does Section 506 Allow?}

Assuming that a creditor has an oversecured consensual lien or an oversecured nonconsensual lien in a jurisdiction which follows the \textit{Best Repair} result, how much interest can the creditor get? The answer varies; a contract, market, or statutory rate is most likely applied.

Generally, gap period interest "should be computed at the rate provided in the agreement under which the claim arose, the so-called 'contract rate' of interest."\textsuperscript{88} Where there is a contract, like a note secured by a mortgage or an Article 9 security interest, courts ordinarily will allow gap period interest at the rate on the face of the note.\textsuperscript{89} Judge Mahoney of the Bankruptcy Court for the District of Nebraska utilizes that rate when available.\textsuperscript{90} The courts using the contract rate give little rationale for doing so. If a court agrees with the \textit{Ron Pair} reading of Section 506(b), that "provided for under the agreement under which such claim arose" modifies "interest on such claim," then

\begin{itemize}
\item \textsuperscript{82} \textit{Id.} at 1082.
\item \textsuperscript{83} \textit{Mack Fin. Corp. v. Ireson}, 789 F.2d 1083 (4th Cir. 1986).
\item \textsuperscript{84} See supra note 62. These courts have found that the statute plainly authorizes gap period interest to all oversecured creditors.
\item \textsuperscript{85} 108 S. Ct. 626 (1988).
\item \textsuperscript{86} \textit{Id.} at 631.
\item \textsuperscript{87} \textit{Id.}
\item \textsuperscript{88} \textit{Collier, Collier on Bankruptcy} ¶ 506.05, at 506-43 (15th ed. 1988).
\item \textsuperscript{89} \textit{In re Lenz}, 74 Bankr. 413, 416 (Bankr. C.D. Ill. 1987); \textit{In re Maimone}, 41 Bankr. 974, 979 (Bankr. D. N.J. 1984); \textit{In re Loveridge Machine & Tool Co.}, 36 Bankr. 159, 161 (Bankr. D. Utah 1983).
\item \textsuperscript{90} \textit{In re Schmit}, No. BK87-1278, slip op. at 1 (Bankr. D. Neb. Sep. 28, 1987).
\end{itemize}
use of the contract rate is sound reasoning. Also, a court may be giving the debtor and creditor the benefit of their bargain.

If the court agrees with Best Repair, the contract might not determine which rate is chosen under Section 506(b). For example, in In re Laza, an oversecured creditor sought a contract interest rate of sixteen percent during the gap period. The court held, however, that Section 506(b) did not require the contract rate and awarded the creditor an eight percent rate, based on current money market opportunities. The court agreed that "interest on such claim" is independent of the modifying clause "provided under the agreement" in Section 506(b). Therefore, rather than binding the court to accept the contract rate, the court held that Section 506(b) authorized a case-by-case determination of a market rate of interest which could be awarded as the gap period interest rate.

At least one court has adopted a case-by-case approach to determine a Section 506(b) interest rate where two contract rates exist. In In re W.S. Shepley & Co., the contract provided for a default rate of interest of twelve percent and a normal, no-default rate of 9.27 percent. An oversecured creditor sought the twelve percent rate under Section 506(b), because the debtor had defaulted on the note. The court concluded that the creditor was entitled only to the lower no-default contract rate. The court used the pre-Code law to create a flexible approach in determining what contract rate to adopt. The court concluded that the lower contract rate should apply for the following reasons: (1) the creditor faced no realistic risk of non-payment of its debt; (2) the lower contract rate was near the market rate; and (3) the increased rate was not justified by an increased risk to the creditor.

Where the oversecured creditor is a nonconsensual creditor (no contract exists) and is in a jurisdiction that allows gap period interest, courts generally award such creditors some statutory rate of interest. For example, in In re Busone, the court held that a county's oversecured tax claim for property taxes was entitled to the interest

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92. Id. at 671.
93. Id.
94. Id.
95. 62 Bankr. 271 (Bankr. N.D. Iowa 1986).
96. Id. at 272.
97. Id. at 278-79.
98. Id. at 278.
100. 71 Bankr. 201 (Bankr. E.D.N.Y. 1987).
rate contained in the statute creating the lien.\textsuperscript{101} Under the \textit{Busone} reasoning, the State of Nebraska may be able to recover fourteen percent interest\textsuperscript{102} on its oversecured real estate tax claims, assuming that the Nebraska bankruptcy courts allow gap period interest on oversecured nonconsensual liens.\textsuperscript{103}

The courts have been faithful to the use of statutory rates in the absence of a contract rate. However, statutory rates are relatively unresponsive to fluctuations in market rates.\textsuperscript{104} If the statutory rate is significantly higher than the market rate, a court might adopt the case-by-case analysis of \textit{Sheppley} in order to use the lower market rate. This result would be more equitable to lower priority creditors, while still allowing the secured creditor to receive a competitive interest rate during the gap period.

H. Summary

Creditors can recover interest on their claims during the gap period of a bankruptcy as outlined below:

(1) Unsecured and undersecured creditors are not entitled to interest payments on their claims during the gap period.

(2) Oversecured consensual claim creditors are entitled to interest under Section 506(b) on their claims. This group of creditors includes valid mortgagees, Article 9 security holders, and other contractual creditors.

(3) Oversecured nonconsensual lien creditors may be entitled to interest, depending upon the jurisdiction in which the case is pending. Not all courts allow interest under Section 506(b) on these claims. This group of creditors generally consists of statutory lienholders.

(4) The rate of interest allowed is generally the specified contract rate. Where no contract exists, courts often use the state statutory rate of interest. A few courts have used a case-by-case analysis and awarded a market rate of interest.

IV. POST-CONFIRMATION INTEREST

The final period in which creditors can seek interest payments on their claims is the post-confirmation period. Sections 1129,\textsuperscript{105} 1225,\textsuperscript{106} and 1325\textsuperscript{107} allow debtors to get a plan of reorganization or rehabilita-

\textsuperscript{101} Id. at 204.
\textsuperscript{102} See \textit{supra} note 61. NEB. REV. STAT. § 45-103 (1984) also gives judgment creditors the right to collect fourteen percent interest on their claim.
\textsuperscript{103} The Nebraska courts have not yet addressed the question.
\textsuperscript{104} Nebraska's rate is adjustable, but the current rate was last changed in 1981. NEB. REV. STAT. § 45-101.01 (1984).
tion confirmed under Chapters 11, 12, and 13, respectively. Plans generally provide for the payment of secured claims over some period of time after confirmation of the plan. Creditors are entitled to have interest added to the future stream of payments in order to realize the present value of their claim. This section discusses the various methods used by courts to determine the appropriate interest rate to be applied to the future payment stream. Particular attention will be given to the recent decisions in the Eighth Circuit.

Chapters 11, 12, and 13 give a bankruptcy court the power to confirm a plan of reorganization over the objections of creditors—the power to "cram down" a plan. Code Sections 1129, 1225, and 1325 set out the requirements that the plan must meet in order to be confirmed. Section 1129 allows a plan to be crammed down, in part, if the secured creditor will receive "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." The legislative history to Section 1129 explains that Congress included this language in order to "recognize the time value of money" by requiring "a present value analysis that will discount value to be received in the future." Courts agree that this cram down provision requires debtors to add interest to their proposed plan payments at a rate equal to the present value discount rate so that the present value of the future stream of payments equals the creditor's allowed secured claim. The question here is what interest rate needs to be used to allow the creditor to realize the present value of its claim. For example, suppose a creditor has a secured claim of $36,000 and objects to confirmation of a plan. The debtor attempts to cram down the plan under Section 1129(b)(2)(A)(i) by making three years of monthly payments to the creditor. Payments of $1,000 per month will not allow the creditor to realize the present value of its claim. The debtor must add some interest, based upon an adequate discount rate, to give the creditor its present value and to meet the cram down test.

Chapters 12 and 13 contain similar confirmation requirements regarding the addition of interest to deferred payments of secured

108. In Chapter 7, property of the estate is liquidated and creditors are paid, without a plan of reorganization being proposed or confirmed. Chapter 9 provides for confirmation of a plan under section 1129, pursuant to 11 U.S.C. § 901 (1982). However, Chapter 9 will not be discussed explicitly.


112. If this point is not clear, see Carbiener, supra note 111, at 43-44.
Courts have recognized that the substantive requirements for payment of interest on deferred payments under a plan are the same for Chapters 11, 12, and 13, even though the confirmation language differs slightly. The legislative history supports this conclusion.

Section 506(b) only applies to the question of receiving interest in the gap period and has no application to the post-confirmation period. While courts occasionally apply Section 506(b) incorrectly to the post-confirmation interest rate determination, most courts recognize that Section 506(b) applies only to determine whether a creditor is entitled to interest in the gap period.

Sections 1129, 1225, and 1325 require that interest be paid on all "secured claims" under a crammed down plan. The bankruptcy court must determine the amount to be paid on a secured claim "as of the effective date of the plan." The Code does not define "effective date." However, the date is important because that date will be used to determine what discount or interest rate will be applied to the deferred stream of payments on the secured claim. If interest rates are volatile, the interest rate paid under a plan can vary depending upon the date that is chosen.

One commentator has suggested that the effective date of a plan usually be the first day after which the order of confirmation becomes final, which under Bankruptcy Rule 8002, would be eleven days after the entry of the order of confirmation if there is no appeal. However, setting the effective date when the confirmation order becomes final has been criticized on the ground that it would then be impossi-

113. 11 U.S.C.A. § 1225(a)(5)(B)(ii) (West Supp. 1988) requires that a plan provide to secured creditors "the value, as of the effective date of the plan, of property to be distributed . . . is not less than the allowed amount of such claim." Chapter 13 incorporates this same requirement under 11 U.S.C. § 1325(a)(5)(B)(ii) (1982).


116. COLLIER, COLLIER ON BANKRUPTCY § 506.05, at 506-44 to -47 (15th ed. 1988).


119. Section 1129(a)(9) also requires that interest payments be included in deferred payments of certain administrative expense claims allowed under § 507.


able to make the present value valuations, because the likelihood of an appeal and the date when the appeal will be resolved cannot be determined in advance of confirmation.\(^{122}\)

Nebraska Bankruptcy Judge Minahan recently decided that, for purposes of Section 1225, "effective date" means the date on which a Chapter 12 plan becomes binding on the debtor and other parties in interest under Section 1227.\(^{123}\) In general, the "effective date" will be the date the confirmation order is entered. Therefore, the discount rate will be determined as of the confirmation order date. Other courts agree that the "effective date" should be on or near the confirmation date.\(^{124}\)

Sections 1141 and 1327 bind the parties in Chapters 11 and 13 as Section 1227 does in Chapter 12, so that, under Judge Minahan's reasoning, one would predict the date of the confirmation order to be the "effective date" in Chapter 11 and 13 cases, also.

The interest rate used to ensure that creditors receive the present value through a deferred payment schedule is important to debtors and creditors. The rate may determine whether a plan is feasible and whether a creditor will accept or reject the proposed plan.\(^{125}\) However, no uniform method to determine a rate exists, and bankruptcy courts within the same circuit often disagree on how to apply court of appeals' opinions on the issue.

A. Methods Used to Calculate Interest Rates in Post-Confirmation Period

Because reorganization plans are often objected to by creditors, courts do need to cram down plans in such a manner that a discount rate needs to be determined for deferred payments of secured claims. Courts agree that few issues under the Code have produced so many opinions with such varied results as the issue of the appropriate interest rate for determining present value. One commentator recently classified the methods of calculating the post-confirmation interest rate into eight categories: (1) the legal or judgment rate; (2) a rate established by expert testimony; (3) a rate established by averaging or using other arbitrary methods; (4) a contract rate; (5) the current market rate for similar loans; (6) the Internal Revenue Service judgment rate set by 26 U.S.C. Section 6621; (7) the rate the creditor must pay to replace the funds; and (8) the federal civil judgment rate set by 18 U.S.C. Section 1961, with or without an additional interest pre-

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\(^{122}\) Pachulski, supra note 15, at 934 n.40.


\(^{125}\) Carbiener, supra note 111, at 43.
mium. After an excellent summary of the case law using each method, the author concluded:

1. Three early courts used the statutory judgment rate of the state with jurisdiction over the case as the discount rate; one because it was convenient, one through a confession of judgment fiction and one because it was a rate designed to compensate creditors for the deprivation of a possessory interest in property.

2. Many courts have cited the absence of evidence on alternative rates when setting the discount rate, but only a few have actually based their choice of a discount rate on expert testimony.

3. Several courts have rejected contract rates because they inappropriately include profit and, instead, they have used either an arbitrary rate . . . or some type of averaged rate as the discount rate.

4. Many courts have set the discount rate equal to the contract rate based on either a misreading of congressional intent, an arbitrary determination that the contract rate was fair, or a finding that the contract rate was the best of several imperfect alternatives.

5. One line of cases . . . [used] the rate currently being charge on the type of obligation which forms the basis of the creditor's claim or the rate currently being charged on the type of obligation the creditor is being forced to enter into under the plan.

6. The rate set by 26 U.S.C. Section 6621 has been used as the discount rate by several courts because it was responsive to economic conditions, periodically revised, and not an unfair burden to debtors.

7. Several courts focus on compensating the creditor for the delay in receiving payment by setting the discount rate equal to the creditor's cost of borrowing, usually the rate on government securities plus one-half percent.

8. Many courts have chosen the rate set by the most recent auction of fifty-two week treasury bills as the discount rate because: it is responsive to current economic conditions as it adjusts every four weeks; it is easy to calculate; it is the risk free cost of money stripped of profit and other elements not appropriate in bankruptcy; and, if an additional premium is necessary, the fifty-two week treasury bill is the appropriate base upon which to build.

B. Eighth Circuit Cases on the Discount Rate

The Eighth Circuit has been somewhat of a leader among the courts of appeals in addressing the issue of an appropriate discount rate, with two of the six circuit opinions discussing the topic. The following is an examination of the Eighth Circuit cases, at the appellate and bankruptcy court levels. The bankruptcy courts have come to different results on how to determine an appropriate discount rate.

In In re Monnier Bros., the debtor appealed a district court deci-
sion setting the cram down rate at the contract rate of thirteen percent, rather than a treasury bill yield of 10.5 percent. The debtor argued that some market rate should be used under the plan. The debtor provided the bankruptcy court with a page from the Wall Street Journal and asked the court to pick an interest rate to serve as the discount rate. The concerned creditor wanted the contract rate as compensation for impairment of its right to foreclose and to give the creditor the benefit of its bargain. The court stated:

The appropriate discount rate must be determined on the basis of the rate of interest which is reasonable in light of the risks involved. Thus, in determining the discount rate, the court must consider the prevailing market rate for a loan of the term equal to the payout period, with due consideration for the quality of the security and the risk of his subsequent default.

The court went on to affirm the district court's use of the contract rate as the appropriate discount rate. However, the facts of the case seem to limit the use of the contract rate on any general basis. The court approved a contract rate, in part, because the contract: (1) was negotiated a short time before the bankruptcy; and (2) like the plan, contemplated a fifteen-year payment term. Therefore, the court seemed to think that the contract rate was equivalent to the market rate and appropriate as a discount rate. Additionally, the court cited the failure of either party to offer much evidence on the market interest rate as support for use of the contract rate. While the court did not say that an evidentiary hearing must be held to determine the discount rate, it did appear to encourage the practice.

In United States v. Neil Pharmacal Co., the Eighth Circuit addressed the question of what rate of interest on deferred payments of delinquent federal taxes would provide the United States with the present value of its claim, as required under Section 1129(a)(9). The debtor's plan proposed to pay the government quarterly interest at the rate paid on thirteen-week treasury bills at the time of each quarterly payment. The government argued that it was entitled to the rate of interest set under 26 U.S.C. Section 6621, the statutory rate for delinquent taxes.
The court reaffirmed the position it took in Monnier that the interest rate used must be a prevailing market rate which is reasonable in light of the risks involved. The court of appeals rejected the debtor's proposal that only the government's cost of borrowing money (the T-bond rate) should determine the discount rate. The court stated that the risk of repayment, the length of the repayment period, and the existence of collateral must also be considered.

The court also rejected Section 6621 as the appropriate measure because that rate lags behind the market rate and does not consider the length of the repayment period and the risk of default under the plan. Finally, the court disapproved of the application of a uniform rate and stressed that the rate should be determined "on a case-by-case basis." The court remanded the case for a hearing on the prevailing market rate of interest.

Based upon Monnier and Neil Pharmacal, the appropriate discount rate must be:

1. A prevailing market rate;
2. For a loan of a term equal to the plan payout period;
3. With due consideration to the existence and quality of security, and the risk of subsequent default; and
4. Determined on a case-by-case basis.

C. Lower Courts in the Eighth Circuit

1. Iowa

Bankruptcy Judge Jackwig of the Southern District of Iowa has tried to add some certainty and convenience to the determination of the appropriate discount rate. In In re Doud, his court considered how the appropriate cram down rate was to be determined in a Chapter 12 plan. The debtors proposed to pay the FmHA an interest rate of 6.5 percent (the T-bond rate plus one percent) on its secured claim.

(1982). Section 6621 was amended so that the interest rate is now based on short-term T-bills plus three percentage points. 26 U.S.C. § 6621 (1986).

139. Id. at 1286. The court found that the T-bill rate alone would not provide the government with the present value of its claim. Id.
140. The lag should be less pronounced since, under the amended section 6621, the rate is recalculated every quarter. 26 U.S.C. § 6621 (1986).
141. United States v. Neil Pharmacal Co., 789 F.2d 1283, 1288. While the Eighth Circuit implied that the section 6621 rate might, therefore, be too low, one commentator also attacked the rate for being too high since it includes a "punitive factor" to deter tax evasion. Carbiener, supra note 111, at 59 n.173. This observation is strengthened by the 1986 amendments to section 6621 which add a three percent factor to the T-bill rate.
143. 74 Bankr. 885 (Bankr. S.D. Iowa 1987).
144. Id. at 886.
The FmHA argued that it was entitled to a “market rate” under Monnier and Neil Pharmacal. The court agreed that the discount rate must be a market rate—consisting of a riskless rate plus a risk factor to account for the risk of a Chapter 12 reorganization. The court concluded that the discount rate in a Chapter 12 would be determined by using the yield on a treasury bond with a remaining maturity matched to the average amount outstanding during the term of the allowed claim, plus a two percent upward adjustment to account for the risk that a creditor must bear under the reorganization. This approach basically requires the attorneys of the interested parties to bring the Wall Street Journal to the confirmation hearing to locate the right T-bond rate and add two percent. Judge Jackwig will use the rate yielded by this method in all discount rate determinations, unless unusual circumstances justify departure from the calculation.

The Iowa bankruptcy courts have expanded the use of the Doud method to calculate the interest rate on deferred payments under a plan. For example, in In re Moore, the court adopted the method to calculate the appropriate rate of interest on an administrative expense under Section 1129(a)(9). However, a 2.5 percent risk factor was added, rather than two percent, because the risks faced by the creditor were greater than those in Doud. The court in In re Noe adopted the Doud formula as a basic, easy way to calculate an interest rate that

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145. Id. at 867.
146. Id. at 868-69. Those risks include the unpredictable nature of the agricultural economy due to factors such as weather, the value of the dollar, foreign production and government policy, and the severity of the agricultural downturn. Id.
147. Id. at 869-70.
148. The rate is the rate of a T-bond with the equal maturity to the average amount of the secured claim outstanding during the repayment period under the plan. For example, where a debtor proposes to pay a $10,000 claim over ten years with equal yearly payments, the average outstanding balance of the claim is $5,500. Therefore, fifty-five percent of the claim is outstanding over the payment period. (5,500/10,000). Since the payment period is ten years, the discount rate will be based on a T-bond with the duration of fifty-five percent of years, or five point five years. This step is necessary since T-bond principal is not repaid over the term of the bond, like the secured claim will be under the plan. Therefore, the court finds the yield on a five point five year T-bond, adds two percent and that is the cram down rate. Id. at 868. Doud adopted the precise method proposed in Carbiener, supra note 111.
149. In Doud, the court did allow the debtor to pay the contract rate on three loans rather than a T-bond plus two percent rate, where the contract rates were lower. The court found that use of the higher rate would thwart FmHA’s goal to assist farmers with low interest rate loans. In re Doud, 74 Bankr. 865, 871 (Bankr. S.D. Iowa 1987).
151. Id. at 514.
152. The court believed that the lack of a trustee and the riskiness of the trucking business of the reorganizing debtor justified a higher risk premium. Id. at 516.
conforms to Monnier for the cram down of a secured creditor under Section 1129(b)(2). The court stated that the use of the method "should obviate the need for complex expert testimony" and that the additional risk factor will satisfy the Eighth Circuit standards.

2. Nebraska

Bankruptcy courts in Nebraska initially used a cram down rate under which the creditor would receive the same rate of return under the plan as it would from any borrower in a class similar to the debtor. In re Scovill addressed the question of an appropriate discount rate under Section 1325 on a secured claim held by a creditor on a car loan. The court held that the creditor was entitled to the same rate it would charge the debtor, as of the effective date of the plan, on a new loan on the vehicle at issue in the case. The court reasoned that, while the debtor was to receive a fresh start, he must be able to function normally in the existing economy; and, therefore, the borrower's rate on a similar loan had to be paid under the plan.

In In re Paul, the court was asked to select an appropriate interest rate to be paid under Section 1325 on arrearages under a home mortgage. The parties submitted several rates for consideration. Following Scovill, the court held that the discount rate must be the rate which a creditor would charge in the current market for the same type of loan, rather than a rate based on T-bonds. However, in In re Wichman, Judge Mahoney changed gears and decided to adopt Doud. Therefore, at least in the Chapter 12 context, and probably in Chapters 11 and 13, Judge Mahoney will use a discount rate based on T-bond yields with a risk factor added. The T-bond plus two percent is presumed to be the appropriate discount rate unless it is totally inappropriate because of special circumstances. The creditor can offer evidence that a different rate should be used. However, under

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153. 76 Bankr. 675 (Bankr. N.D. Iowa 1987).
154. Id. at 678.
155. Id.
157. Id. at 635.
159. The average T-bond rate was 7.97 percent, the contract rate was 15.75 percent, the current thirty-year mortgage rate was 10.125 percent and the current rate for a three-year loan (same duration as the plan payments) secured by real estate was 10.75 percent. Id. at 270.
160. Id. at 270-71. Therefore, the court selected the 10.75 percent rate.
162. Id. at 721-22.
163. Id. at 722.
Wichman, exceptions to the use of the Doud formula probably will be few.

Wichman adopted the Doud formula for several reasons. First, the court cited the general worthlessness of expert testimony for setting the discount rate.\textsuperscript{164} Second, the Doud formula eliminates expert testimony in most cases, saving time and money for the parties. For these reasons, Judge Mahoney moved away from the rate the creditor would charge on a similar loan in favor of the T-bond plus two percent formula in Doud.\textsuperscript{165}

In \textit{In re Milleson},\textsuperscript{166} Judge Minahan held that the Wichman formula would not pay a creditor the present value of its secured claim as required by Section 1225.\textsuperscript{167} Instead, the court found that the creditor, a large agricultural lender, was entitled to the rate of interest it was currently charging high-risk borrowers. The rate allowed was higher than the rate dictated by Wichman. Milleson more closely resembled the approach used in Scovill and Paul. But, the court did not reject Wichman, stating instead that Wichman was inapplicable.

3. Missouri

At least one opinion in Missouri has adopted the Doud formula. In \textit{In re Bartlesmeyer},\textsuperscript{168} the court agreed generally with Doud that the T-bond rate forms the basis of the interest rate on deferred payments in Chapter 12.\textsuperscript{169} However, the court approved only a one-percent risk premium, stating that the risk of unexpected depreciation is the only basis on which to add a premium to the T-bond rate.\textsuperscript{170} Where there is no likelihood of depreciation, the creditor will only be allowed a T-bond rate.\textsuperscript{171}

Bankruptcy courts in Iowa, Nebraska, and Missouri currently read Monnier and Neil Pharmacal to allow a T-bond plus risk factor ap-

\textsuperscript{164} Id. at 720.
\textsuperscript{165} The Wichman formula was applied in \textit{In re E Bar V Angus Ranch Co.}, No. BK87-801, slip op. (Bankr. D. Neb. Nov. 9, 1987).
\textsuperscript{167} Id. at 699.
\textsuperscript{168} 78 Bankr. 975 (Bankr. W.D. Mo. 1987).
\textsuperscript{169} Id. at 977.
\textsuperscript{170} Id.
\textsuperscript{171} Bartlesmeyer differs from the same court's view in Chapters 11 and 13. Missouri courts had previously used the state legal rate as the cram down rate in those contexts. See \textit{In re Johnston}, 44 Bankr. 667 (Bankr. W.D. Mo. 1984); \textit{Matter of Coburn}, 36 Bankr. 550 (Bankr. W.D. Mo. 1983). In \textit{In re C & P Gray Farms, Inc.}, 70 Bankr. 704 (Bankr. W.D. Mo. 1987), the court approved the use of the state legal rate, even though the creditor argued that it could get a higher rate of interest in the market. See also \textit{In re Fowler}, No. 87-02970-SJ-13 (Bankr. W.D. Mo. Aug. 9, 1988), where the court approved the use of the section 6621 rate because the parties did not present evidence of the prevailing market rate. It is not yet clear whether Bartlesmeyer will be applied to the Chapters 11 and 13 contexts.
proach to deriving a plan discount rate. However, courts in North Dakota, Minnesota, and Arkansas use different methods, rejecting the T-bond approach.172

4. North Dakota

North Dakota has developed a “creditor-specific” approach in setting the appropriate discount rate. In In re Claesy,173 the court expressly rejected the Doud formula as a means to establish a discount rate in Chapter 12 because the method “seems arbitrary and unnecessary, particularly in those cases in which... a lender has introduced testimony bearing on the very issue.”174 The court found that Monnier and Neil Pharmacal clearly require the court to consider what the prevailing market rate would be for a loan of equal term and the factor and the risks involved in such a loan. Therefore, “the best evidence of what a discount rate ought to be is what a similar loan to a debtor in similar circumstances would cost in the marketplace.”175 Because “a creditor’s own testimony as to what [rate] it would charge for a loan under a given set of circumstances best reflects upon each of the required inputs,” the court set the discount rate at a rate only slightly below what the creditor would have charge a one hundred percent leveraged borrower.176

Claesys is consistent with other North Dakota opinions on determining a discount rate.177 The court has used the creditor-specific rate to set the discount rate even where the creditor’s rate is substantially higher than other market rates, like T-bond yields.178

5. Arkansas and Minnesota

Bankruptcy courts in Arkansas and Minnesota apparently agree that a T-bond rate is not appropriate as a discount rate. For example, in In re Landscape Associates,179 the court stated that the “appropriate rate of interest for calculating the present value of a claim is the current market rate for a loan under similar circumstances.”180 The

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172. South Dakota is also in the Eighth Circuit. However, research has not uncovered a South Dakota case addressing the discount rate issue.
174. Id. at 993.
175. Id.
176. Id. at 933-94.
177. See In re Konzak, 78 Bankr. 990 (Bankr. D.N.D. 1987)(Chapter 12 must use rate creditor would charge debtor in the market place absent bankruptcy as a discount rate).
178. In In re Edwardson, 74 Bankr. 831 (Bankr. D. N.D. 1987), the court approved the creditor’s base rate on standard farm loans of twelve percent as the discount rate under section 1225, even though T-bond rates were at 8.5 percent.
180. Id. at 487.
court rejected the prime rate as found in the Wall Street Journal as the appropriate discount rate. Similarly, in construing Monnier, the court in In re Citrowske stated "the interest rate which the creditor involved would charge to the debtor in the present regular loan market is presumptively the correct interest rate" for determining the discount rate under Section 1225.

The courts in North Dakota, Arkansas, and Minnesota apparently allow the particular creditor facing deferred payments of a secured claim to set its own discount rate, consistent with other loans it is making. In probably every case, this rate will be higher, maybe whole percentage points higher, than the formula approach used in Iowa, Nebraska, and Missouri. Yet, both lines of cases claim to be consistent with Monnier and Neil Pharmacal.

D. What is the Correct Rate?

Even though bankruptcy courts in the Eighth Circuit have Monnier and Neil Pharmacal as guidance, neither opinion gives much assistance to bankruptcy courts when an actual discount rate must be determined. This may account for the dissimilar methods used within the circuit to determine the rate. Both methods used comply with the vague language used by the court of appeals.

The court of appeals first requires that the discount rate be a "prevailing market rate," even though the confirmation sections of Chapters 11, 12, and 13 do not so state. Also, the legislative history refers to "the discount rate" rather than a market rate. Whether there is, in fact, a real difference in the two concepts, is probably immaterial because courts generally agree that some market rate should be used. The problem is which market rate.

The Doud line of cases adopts a market rate. This rate is respon-

181. Id. at 488. The debtor did not propose to add a risk factor in this case like the method approved by Doud.
182. 72 Bankr. 613 (Bankr. D. Minn. 1987).
183. Id. at 617.
184. See supra note 137 and accompanying text.
sive to current economic conditions and is easy to calculate. These conditions are recognized as common to all market rates. The North Dakota line of cases—the creditor-specific approach—use another type of market rate. The creditor-specific approach is responsive to economic conditions—adjustments must be made by all creditors to remain competitive or creditors risk losing money when rates are rising or losing customers when rates are falling. The creditor-specific rate is easy to determine by just asking the creditor. Therefore, both lines of cases meet the first test of Monnier and Neil Pharmacal.

Second, bankruptcy courts must set a discount rate based on a loan of a term equal to the payout period of the plan. The Doud formula does this by utilizing a T-bond yield equal to the same percentage of the repayment period as the average percentage of the claim outstanding during the payments under the plan. The creditor-specific approach satisfies this requirement by using the rate the creditor would charge the debtor for a loan of the same duration as the payments under the plan.

Third, there must be due consideration to the existence and quality of the security and risk of subsequent default. The “risk factor” of Doud is meant to specifically compensate for these factors. Similarly, the creditor-specific approach satisfies this test because, presumably, these considerations are already loaded into the creditor’s rates that it would charge the debtor for a loan of a similar loan.

Finally, the discount rate must be determined on a case-by-case basis. The creditor-specific approach obviously meets this test because the particular creditor is required to show what rate it would currently charge the debtor on a similar loan. Doud, and especially Wichman, create a presumption that the T-bond plus two percent approach will be used to establish the discount rate. Significantly, however, each opinion left open the ability of a creditor to challenge the formula rate and show why it was inappropriate. Therefore, arguably, the Doud line of cases allow for a modified case-by-case determini-

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187. The auction method of selling treasury certificates may be one of the purest forms of determining what the market will pay for the use of money.
188. Treasury bond yields are very easy to find in the financial section of most major newspapers.
190. Presumably, a court will require a creditor to justify its rate to ensure it is the rate a debtor could get.
191. See supra note 138 and accompanying text.
192. See supra note 146 and accompanying text; Carbiener, supra note 111, at 64-65.
193. See supra note 131 and accompanying text.
196. See supra note 141 and accompanying text.
nation.\textsuperscript{198} Apparently, both formulas used by the Eighth Circuit bankruptcy courts comply with \textit{Monnier} and \textit{Neil Pharmacal}. Is there any compelling reason to use one over the other?

The \textit{Doud} formula has two advantages over the creditor-specific approach. First, application of the formula should save significant amounts of court time and attorney fees because fewer hearings will be necessary to determine the appropriate discount rate. In \textit{Wichman}, Judge Mahoney indicated that the additional delay and expense of the creditor-specific approach made such a method too burdensome and sometimes useless.\textsuperscript{199} Second, the \textit{Doud} formula offers an easy way to determine the discount rate. The easy availability of a certain rate is beneficial to both parties. The debtor and creditor save time and money in arriving at a discount rate because no court hearing is necessary. Also, a certain rate helps both parties evaluate the feasibility of a proposed plan.\textsuperscript{200} By having a certain discount rate to work with, a proposed plan can address accurately whether the organization is feasible because outlays under the plan will be more predictable.\textsuperscript{201}

The creditor-specific method has been criticized as a method for setting the discount rate for two reasons. First, most courts agree that an appropriate discount rate should not include profit to the secured creditor, finding instead that any profit should go to pay other claimants.\textsuperscript{202} However, the creditor-specific rate does include some profit for the creditor because it is the same rate the creditor would normally charge, and a creditor usually includes some profit premium in the interest rate it charges.\textsuperscript{203} Second, creditor-specific rates also include premiums for other costs related to a lending transaction, such as costs for borrower screening and delinquent loan collection. Because these costs arguably may be eliminated or reduced in bankruptcy, a discount rate should not include premiums reflecting these

\textsuperscript{198} It remains a question as to how diligently the courts will follow the T-bond plus two percent rate presumption and whether it can be challenged effectively.

\textsuperscript{199} In re \textit{Wichman}, 77 Bankr. 718, 720 (Bankr. D. Neb. 1987). Judge Mahoney indicated that testimony in hearings to set a discount rate may result in experts "conjur[ing] up" a discount rate.

\textsuperscript{200} There may be times where the redetermination of the discount rate may cause a court to reject the plan and possibly dismiss the case. See \textit{In re Landscape Assoc.}, 81 Bankr. 485 (Bankr. E.D. Ark. 1987). Adding certainty to the discount rate determination will help to prevent such surprises.

\textsuperscript{201} Even if T-bond rates as of the confirmation date are used, a plan should be able to be drawn up with a good idea as to what the rates will be.


\textsuperscript{203} Carbiener, \textit{supra} note 111, at 60.
The additional premiums for profit and costs of administration reflected in the creditor-specific rate are not present in the T-bond yield rate.

Because both methods used seem to be consistent with Monnier and Neil Pharmacal, the facts suggest that bankruptcy courts make a decision as to who will bear the expense of bankruptcy—the expense being the difference between the creditor-specific rate and the Doud rate. Where a court is concerned with convenience and other creditors, it should adopt the Doud formula. That formula is easy and less expensive to apply and does not include a profit component for the creditor holding the claim being paid down on a deferred basis. By denying the creditor a profit premium under the plan, the creditor is forced to forego a portion of the present value of its claim. If the creditor had the money to lend as of the confirmation date, it could earn this profit premium. Therefore, the creditor holding the claim bears the cost of a more efficient process and increased payments to other lower priority creditors.

If a court believes that the secured creditor is entitled to some profit during the plan payment period, the creditor-specific approach is most appropriate. Then a creditor actually could realize the entire benefit of its claim under the plan. A profit premium loaded into the discount rate would place the creditor in the same position as if it had the claim amount to lend as of the confirmation date. Under the creditor-specific approach, the debtor and other creditors incur the expense of this profit premium payment to the secured creditor.

Currently, the bankruptcy courts are equally divided, in terms of jurisdictions, as to which method should be used. Both methods seem justified under the current Eighth Circuit Court of Appeals’ opinions. However, because significant differences may exist in the discount rates arrived at using the alternative methods, the court of appeals should step in and finally clarify the issue.

V. CONCLUSION

Getting interest on a claim in the context of bankruptcy is restricted to a select group of creditors. All creditors are allowed to assert a claim for pre-petition matured interest. However, once a petition is filed, the interest clock is turned off. Only creditors with oversecured consensual liens are assured of interest during the gap period. In some jurisdictions, oversecured nonconsensual liens also accrue gap period interest. When gap period interest is allowed, it becomes part of the secured claim to the extent of any equity cushion.

All secured claims paid on a deferred basis pursuant to a plan of reorganization are entitled to post-confirmation interest. However,

204. Id. at 61.
the methods to determine the appropriate post-confirmation rate vary a great deal.

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