REJECTING THE MARIE ANTOINETTE PARADIGM OF PREJUDGMENT INTEREST

Royce de R. Barondes*

Let them eat cake.¹

I. INTRODUCTION

A promisee is on the brink of insolvency. Its promisor, which has very good credit – perhaps an entity whose obligations are guaranteed by the federal government – defaults. Is the promisee made whole by receiving prejudgment interest at the rate the market charges the promisor? The most thorough recent analysis in the legal literature of prejudgment interest² – an article that has received a mixed reception in the courts³ – provides an affirmative answer.⁴ That rate, it is argued, properly compensates plaintiffs.⁵

¹ RESPECTFULLY QUOTED: A DICTIONARY OF QUOTATIONS REQUESTED FROM THE CONGRESSIONAL RESEARCH SERVICE 253 (Suzy Platt, ed., 1989) (stating quotation is commonly attributed to Marie Antoinette, but stating the author is unknown and recounting disagreement concerning proper attribution).


³ E.g., Cement Div., Nat'l Gypsum Co. v. City of Milwaukee, 144 F.3d 1111, 1114 (7th Cir. 1998) (noting that use of defendant-municipality's cost of funds is only permissible, not mandatory); Cement Div., Nat'l Gypsum Co. v. City of Milwaukee, 950 F. Supp. 904 (E.D. Wisc. 1996) (denying request to strike a draft of the article from the record), aff'd, 144 F.3d 1111 (7th Cir. 1998); Cayuga Indian Nation of New York v. Pataki, 165 F. Supp. 2d 266, 286–87 (N.D.N.Y. 2001) (quoting the article to the effect there would be no need for prejudgment interest were justice immediate); Barbato v. Paul Revere Life Ins. Co., 794 A.2d 470, 472 (R.I. 2002) (favorably referencing desirability of discounting future damages to the date of injury and then calculating prejudgment interest on that award); Blue Ribbon Beef Co. v. Napolitano, 696 A.2d 1225, 1230 n.4 (R.I. 1997) (same).

Although not noted in the initial footnote to Knoll's piece, Knoll, supra note 2, at 293 n.*;
The basic principle underlying this view is that prejudgment interest essentially represents compensation for a forced investment a promisee is required to make in the promisor. Thus, the promisee is made whole by having the investment bear interest at the promisor’s cost of funds.

One might term this view the “Marie Antoinette” approach to prejudgment interest: although the promisee expected immediate payment (bread), it should be satisfied with later payment, bearing interest at a market rate for an investment in the promisor (cake). If the promised substitute performance could be transferred without transaction costs, the promisee could simply sell the claim (cake) and get cash (use the cash to buy bread). However, even to the extent claims can lawfully be sold, transaction costs cannot typically be ignored. Claims in default are not fungible; their value depends on the existence of any defenses. Substitution of an illiquid asset, even if properly valued, may not make the promisee whole.

This paper develops the theoretical rationale for the conclusion suggested by this intuition. In brief, the error is that prejudgment interest at the promisor’s cost of funds grants a promisor the ability to reallocate value from the promisee’s equityholders (or the promisee itself, in the case of an individual promisee) to its creditors. The final extension of the analogy is perhaps strained: the promisor gets to reallocate value among members of a family unit, from the parents, who want bread, to the kids, who want cake.

The contribution made by this paper concerns development of the theoretically correct computation of prejudgment interest in claims for breach of contract between large business entities. This analysis is useful in assessing the merits of the ways in which prejudgment interest is, in fact, calculated in particular jurisdictions. This paper foregoes a comprehensive compilation of the black letter law of prejudgment interest or a summary of academic commentary concerning prejudgment interest from a doctrinal perspective, as part of an exhaustive application of theoretical principles developed in this paper to all contexts. That is because a compilation of the black letter law of prejudgment interest would be prohibitively lengthy, and, given the exhaustive existing

Knoll acted as an expert for the defendant, the City of Milwaukee, in Cement Division, National Gypsum Co. v. City of Milwaukee, 950 F. Supp. 904, 911 (E.D. Wisc. 1996) (denying request to strike a draft of the article from the record). Consistent with the views Knoll expresses in his article, it was the defendant’s position, inter alia, that prejudgment interest should be based on the defendant’s cost of funds. Id. at 907.

4 Knoll, supra note 2, at 311.

5 Id.

6 Id. at 314.

7 See Part VI, infra (discussing limits on the sale of claims).
commentary concerning the availability of prejudgment interest in assorted contexts, little would be added by recounting that here. Various factors

contribute to the detail-intensive nature of the black letter law of prejudgment interest. One type of variation among jurisdictions concerns whether prejudgment interest is available at all. For example, prejudgment interest may be limited to liquidated claims, or it may be provided on a discretionary basis.

It also may be affected by settlement offers. Another dimension of the variation involves the computation methodology. There is a wide range in the pertinent rates. The choice of rate may be discretionary, and jurisdictions vary as to whether the interest is simple or compound.

One manifestation of both the diversity of treatments at law and the importance of computing prejudgment interest, as a practical matter, is the

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Williams, Comment, Prejudgment Interest: An Element of Damages Not to Be Overlooked, 8 CUMB. L. REV. 521 (1977); H. Deane Wong, Prejudgment Interest: Too Little, Too Much, or Both?, 10 UCLA-ALASKA L. REV. 219 (1981) (collecting authority and focusing on Alaska law). This law review commentary is supplemented by extensive annotations. See infra notes 15-16 and accompanying text.

The principal authority in the scholarly legal literature focusing on the theoretically proper compensatory rate is Knoll, supra note 2, and John C. Keir & Robin C. Keir, Opportunity Cost: A Measure of Prejudgment Interest, 39 BUS. LAW. 129 (1983).

CHARLES T. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 54, at 213 (1935). McCormick formally defines liquidated claims as those in which “it [is] possible to compute the amount with exactness, without reliance upon opinion or discretion,” providing as examples fixed sums. Id. McCormick also indicates the better result is that prejudgment interest is available on claims “for which the measure of recovery is based upon a valuation of property or services having a market or established current value.” Id. § 55, at 217. Accord 1 DAN B. DOBBS, DOBBS LAW OF REMEDIES § 3.6(1), at 336 (2d ed. 1992) (identifying a general rule that, absent statutory modification, “prejudgment interest is not recoverable on claims that are neither liquidated as a dollar sum nor ascertainable by fixed standards”); Knoll, supra note 2, at 298 (describing this approach as the “widely rejected” common law rule). See generally MCCORMICK, supra, § 54, at 213 (indicating the better rule is a claim is liquidated notwithstanding dispute as to liability).

Douglas, supra note 8, at 292–95; Gaston, supra note 8, at 362.


See Palmer, supra note 8, at 708 (identifying default rates ranging from five percent to twenty percent).

See Knoll, supra note 2, at 299–300.

See id. at 299 n.35 (describing simple interest as “[t]he most common incorrect computational method”); cf. Keir & Keir, supra note 8, at 145 (concluding compound interest should be awarded).
extensive array of practitioner-oriented treatments of the subject. For example, there are numerous American Law Reports annotations focusing individually on prejudgment interest in particular types of claims or contexts, in addition to annotations examining prejudgment interest as a component of a larger investigation.

The remainder of this paper proceeds as follows, examining the proper computation of prejudgment interest in breach of contract claims between large business entities: As a threshold matter, one might argue that the choice of rate makes no difference, because parties will simply contract around the rate selected as a default. Part II briefly indicates why that is not the case — why the default rate matters. Part III then summarizes prior theoretical analyses of the proper selection of rates for prejudgment interest, focusing on the most prominent, recent analysis in the legal literature, which concludes prejudgment interest at the promisor’s cost of funds should be provided.

Using examples where the promisee has a higher cost of funds than the promisor, Part IV illustrates how that approach conflates value received by creditors and shareholders of a corporate plaintiff. It allows a creditor, in

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17 Knoll, supra note 2, at 311.
default, to reallocate value from the promisee’s shareholders to the promisee’s creditors, ultimately undercompensating shareholders. Part V then examines circumstances where the promisor has a higher cost of funds than does the promisee, and concludes that prejudgment interest at the promisor’s cost of funds may overcompensate promisees. The basic principle is that the promisor’s cost of funds reflects both the risk of a short-term default plus the incremental increase in risk arising from postponed payment. However, providing prejudgment interest to compensate for the former (short-term default risk) produces hyper-complexity in prejudgment interest and may result in overcompensation of promisees.

For ease of illustration, those examples and analyses are focused on promisees and promisors with simple financial structures—unsecured debt and common stock. The analyses in Parts IV and V are based on a hypothetical covering transaction funded by an unsecured loan from a third party. Part VI refines those analyses by examining the possibility that a promisee could sell the claim or fund a covering transaction with nonrecourse debt.

II. IMPORTANCE OF THE CORRECT RATE – IT IS NOT SIMPLY PRICED-IN

This paper explores the proper rate at which prejudgment interest should be granted in claims for breach of contract between large business entities, starting from the assumption that the goal is to provide proper compensation to a plaintiff, probing the validity of prior analyses. As a preliminary matter, one might assert that the rate of prejudgment interest is “priced-in” to contracts and, therefore, the rate selected by the law makes no difference.

For familiar reasons, there are a few problems with that analysis. First, there is no bargaining at all for some plaintiffs—many are tort claimants—and improper computation of prejudgment interest may reallocate value among tort and contract claimants. Second, if prejudgment interest introduces unnecessary complexity in predicting, at contract formation, the potential outcomes upon subsequent default, that imposes wasteful expenditures to assess possible outcomes. It also may introduce unnecessary risk in contracting, imposing cost by needlessly increasing uncertainty as to the outcome upon

\[18\] Similar observations are made in connection with assessing priority of tort claimants against insolvent debtors. E.g., Lynn M. LoPucki, The Unsecured Creditors’ Bargain, 80 VA. L. REV. 1887, 1897–98, 1963 (1994) (asserting the existence of involuntary creditors, such as tort claimants, may explain the existence of secured debt and concluding, “Involuntary creditors should have priority over voluntary creditors, whether secured or unsecured.”).
subsequent default. Third, variation between parties in terms of their ability to predict the likelihood of default means pricing-in the cost does not produce an equivalent outcome. An efficient outcome allocates risks to a party better able to assess or control those risks.\(^1\) A promisor is generally better able to assess and control the likelihood of its own default. Even if the cost of insufficient prejudgment interest is priced-in, that outcome would be inferior to one in which properly computed prejudgment interest is provided. It could yield undesirable risk allocations.

Even for parties that can opt out of defaults, the default rules matter. Traditional theory supports defaults reflecting the bargain the parties would have reached had they been express about the point,\(^2\) because there are costs to negotiate out of a default provided by law.\(^3\) These transaction costs will impede some parties in opting-out of a default rule that fails to provide appropriate compensation for prejudgment interest.

In sum, concerns with undercompensatory or overcompensatory prejudgment interest cannot be dismissed on the basis that claimants will have priced-in the inadequate remedy. It can provide suboptimal outcomes that some will not opt-out of, because of transaction costs, and, more generally, may reallocate value among parties with varying abilities to negotiate around defaults.

\(^{19}\) See Richard A. Posner, Economic Analysis of Law 97, 106 (6th ed. 2003) (illustrating control over risk as a basis for allocation of its consequences and identifying as a factor in determining the cheaper insurer (i.e., risk-bearer) the ability to measure the risk).

\(^{20}\) E.g., id. at 96 ("The task for a court asked to interpret a contract to cover a contingency that the parties did not provide for is to imagine how the parties would have provided for it had they thought to do so."); Charles J. Goetz & Robert E. Scott, The Mitigation Principle: Toward a General Theory of Contractual Obligation, 69 Va. L. Rev. 967, 971 (1983) ("Ideally, the preformulated rules supplied by the state should mimic the agreements contracting parties would reach were they costlessly to bargain out each detail of the transaction."). But see, e.g., Ian Ayres & Robert Gertner, Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules, 101 Yale L.J. 729, 733 (1992) ("These results strengthen the growing consensus among contract scholars that default rules should not simply be the hypothetical contract that parties would choose in a world without transaction costs. The hypothetical contract standard fails to account for the inefficiencies that can be caused by strategic bargaining under conditions of asymmetric information and how these inefficiencies depend upon, and can be exacerbated by, the costs of contracting around a given default rule. When the parties have symmetric information, the hypothetical contract standard yields efficient results. When the parties have asymmetric information, however, the hypothetical contract standard fails to provide an effective framework for choosing efficient rules." (footnote omitted)).

\(^{21}\) Cf. Ayres & Gertner, supra note 20, at 732 (proposing irrelevance of default rule where it is well-known and the parties can opt out of the default without cost).
For complex reasons, one may argue a default that does not provide proper compensation should be adopted. Ayres and Gertner's "penalty default" is a prominent candidate. Yet even if one seeks to provide undercompensatory or overcompensatory prejudgment interest, as part of a complex, putatively efficient mechanism, a preliminary step in the development of the proper rate would be identification of the fully compensatory rate. Determining what is the fully compensatory rate of prejudgment interest is thus an important part of any attempt to examine the merits of a particular proposed rate of prejudgment interest, even if the goal is to provide overcompensatory or undercompensatory interest.

III. ALTERNATIVE APPROACHES IN THE LITERATURE

Focusing on litigation between large corporate commercial actors, recent literature includes three general categories of conclusions concerning the method for computing prejudgment interest: the defendant's borrowing cost, the plaintiff's cost of funds, and the risk-free rate. The theoretical development of, and support for, each of the three approaches seems plausible.

A. Defendant's Borrowing Cost

The most comprehensive discussion in the legal literature of the theoretical principles for setting prejudgment interest rates is provided by Knoll. He argues the proper treatment requires providing prejudgment interest at the defendant's cost of borrowing, at least where the defendant and the plaintiff are large firms with access to the capital markets. His theory is that the defendant has essentially made a forced loan to the plaintiff. The underlying concept is that the market essentially accurately prices debt obligations. Therefore, if prejudgment interest is at the defendant's cost of borrowing, that turns prejudgment interest into an investment (albeit an involuntary one) that is properly priced.

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23 Knoll, supra note 2.

24 Id. at 305, 310–11.

25 Id. at 314.

26 Various details arising in the specification of interest rates are thoroughly addressed by Knoll, supra note 2, e.g., seniority of the referenced interest rate, the time horizon, tax
Knoll rejects using the plaintiff's cost of borrowing, arguing that, where the plaintiff's cost of borrowing is less than that of the defendant, providing prejudgment interest at the plaintiff's lower rate does not compensate the plaintiff for risk of nonpayment. He also argues it is improper to use the plaintiff's cost of borrowing in the converse case, where the plaintiff's cost of borrowing is higher than that of the defendant:

The plaintiff's borrowing rate on the withheld funds would not exceed the defendant's if the hypothetical lender to the plaintiff were assured of payment in the event that the defendant pays the plaintiff. The hypothetical lender, however, is not so assured, conditional on the judgment being paid, because other claimholders in the plaintiff also have a right to share in the award. Hence, they too will benefit from the award because they might receive a larger payment than otherwise. Thus, awarding prejudgment interest at the plaintiff's cost of borrowing will overcompensate the plaintiff.

An earlier analysis by Patell et al. concludes that, where the claim is transferable, it should bear interest at the defendant's cost of funds. On the other hand, they develop a somewhat complex model in which a risk-averse plaintiff needs greater compensation where the claim cannot be sold.

B. The Plaintiff's Cost of Funds

Keir and Keir focus on the injury to the plaintiff arising from the litigation delay. They argue that where the plaintiff is a business, the rate of prejudgment interest should be at least the plaintiff's cost of capital. They reference the consequences and multiple defendants who are jointly and severally liable. Those details are not addressed in this paper.

27 Id. at 314-15.
28 Id. at 315 (footnote omitted).
30 Id. at 354.
31 Id. at 357-62.
32 Keir & Keir, supra note 8, at 151-52. Keir and Keir also conclude that where a business plaintiff's historical rate of return is higher, prejudgment interest can properly be set up to that rate. Id. at 152. Escher and Krueger similarly focus on the plaintiff's cost of carrying the assets. Susan Escher & Kurt Krueger, The Cost of Carry and Prejudgment Interest, 6 LITIG. ECON. REV. 12, 16 (2003). Ault and Rutman, in a brief piece, raise the issue of whether prejudgment interest should be calculated to compensate for "loss of control over the use of... funds." David E. Ault & Gilbert L. Rutman, The Calculation of Damage Awards: The Issue of "Prejudgment Interest," 12 J. FORENSIC ECON. 97, 104 (1999).
firm's weighted average cost of capital, based on its cost of debt, common stock, and preferred stock.\textsuperscript{33}

For ease of exposition, the distinction between the firm's cost of debt and its weighted average cost of capital is disregarded in this paper. Except where the claim in question is relatively large, one would expect promisees to look to their existing lines of credit, or other sources of borrowed funds, to cover the claim in question, as opposed to selling stock. Ultimately, firm-specific factors will materially influence how a claim is covered in particular cases.

Lanzillotti and Esquibel reach a conclusion somewhat similar to Keir and Keir, concluding without a detailed discussion that, where the plaintiff was a net borrower in the prejudgment period, prejudgment interest should be based on the plaintiff's cost of borrowing.\textsuperscript{34}

Keir and Keir also examine whether prejudgment interest based on the defendant's cost of funds, representing the defendant's profit arising from the time delay of litigation, should be awarded. They assert that as it represents an approach sounding in restitution, it should not be available where the underlying claim is legal – but available where the action is in equity.\textsuperscript{35}

C. Risk-Free Rate

Fisher and Romaine assert prejudgment interest should be at the risk-free rate.\textsuperscript{36} They consider two plaintiffs with different borrowing costs. They argue that to give a higher rate of prejudgment interest to one "is to forget that his higher average rate of return compensates him for the risk associated with his investments .... The asset destroyed might perfectly well have been employed in an unsuccessful venture; that risk has not been borne."\textsuperscript{37} They further assert, "[S]ince that higher rate stems from causes having nothing to do with the violation, there is no reason why [the one with the higher cost of funds] should be compensated at a higher rate than [the other]."\textsuperscript{38}

\textsuperscript{33} Keir & Keir, \textit{supra} note 8, at 147–48.
\textsuperscript{35} \textit{See} Keir & Keir, \textit{supra} note 8, at 140–41.
\textsuperscript{37} \textit{Id.} at 146–47.
\textsuperscript{38} \textit{Id.} at 147 n.4.
D. Intuition for Choosing Among Theories

Each of these analyses seems plausible. Four insights are useful in developing an intuitive sense in selecting among these approaches. The intuition is first discussed in the remainder of this Part, and then, in Parts IV and V, illustrated with quantitative examples.

The first insight is to distinguish among corporate constituencies. Paring down Knoll’s language, focusing on the constituency one has in mind illuminates the problem with Knoll’s analysis. As to awarding interest at the plaintiff’s cost of borrowing, he asserts: "[O]ther claimholders in the plaintiff . . . will benefit from the award . . . . Thus, awarding prejudgment interest at the plaintiff’s cost of borrowing will overcompensate the plaintiff."39 The discussion erroneously equates “other claimholders” with the plaintiff itself.

The second insight involves incremental increases in risk of ultimate nonpayment arising from postponed payment. Assume a promised performance is due at Time 1, having a value if rendered immediately of $100. The promisor defaults, litigation ensues and judgment is entered at Time 2. One can conceptualize the value to the promisee, as of Time 1, of the promise as being the product of four separate factors: (i) $100, the face value of performance; (ii) the promisor’s financial solvency at Time 1; (iii) the incremental increase in the risk the promisor will become insolvent from Time 1 to Time 2; and (iv) the value of having money at Time 1 as opposed to Time 2. The face value of the promise due may reflect part of the default risk, estimated at the time the contract was formed. For example, if I default on my mortgage loan at Time 1, the payment due will reflect the lender’s assessment, at the time the loan was extended, that I would default. If prejudgment interest is based on the risk of solvency at Time 2, without adjustment for any portion of the default risk reflected in the amount due, providing prejudgment interest based on the promisor’s cost of funds includes some double-counting. As developed more fully below, a thoughtful resolution would exclude from computation of prejudgment interest the amount the promisor pays, at Time 1, on short-term borrowing attributable to default risk.

This insight allows rejection of the view expressed by Keir and Keir, that prejudgment interest reflecting the promisor’s default risk should not be provided where the underlying claim is legal.40 Litigation provides a promisor the option to postpone payment, which may increase the likelihood that the

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39 Knoll, supra note 2, at 315 (emphasis added).
40 See supra note 35 and accompanying text.
promisee will not be paid in full. That increased risk is a component of the promisor's cost of borrowing. Providing compensation based on (a component of) that cost of borrowing is not, then, divorced from properly compensating the promisee, as is suggested by their dichotomous treatment of claims at law and those in equity. The notion that prejudgment interest reflecting the promisor's default risk should be restricted to claims that are not at law is, therefore, erroneous. Accounting for that increased risk may be required to compensate a promisee fully, and can be fully consistent with the goal of a remedy at law to compensate a promisee fully.

The third insight allows rejection of the Fisher and Romaine proposal to reference the risk-free rate. Their assertion, "[S]ince that higher rate stems from causes having nothing to do with the violation, there is no reason why [the one with the higher cost of funds] should be compensated at a higher rate than [the other]," is inconsistent with basic elements of damage computations. Attributes of plaintiffs are frequently taken into account in ascertaining damages, whether in tort, e.g., the "eggshell skull" plaintiff, or in contract, e.g., consequential damages. Perhaps most apposite is a breach of an obligation to lend, where it is not at all controversial to conclude damages are based on the borrower's cost of acquiring substitute funds.

Along similar lines, the limitation proposed by Lanzilotti and Esquibel, limiting the plaintiff's recovery based on its cost of funds to circumstances where it was a net borrower in the prejudgment period, does not seem correct. Even if the plaintiff's outstanding debt remained constant in the prejudgment period, where the debt could have been prepaid without penalty, the defendant's failure to pay immediately on breach would deprive the promisee of this option.

41 Fisher & Romaine, supra note 36, at 147 n.4.
45 See supra note 34 and accompanying text.
The breach, of course, frequently will prevent definitive proof of what the promisee would have done absent breach.

For purposes of this paper, the discussion focuses on the promisee’s cost of funds, without exploring the details where there is a discrepancy between the rate of current debt the promisee could prepay and the rate at which the promisee would, at that point in time, be required to agree to pay for a loan extended at that time. Focusing on that level of detail would obscure the basic points being made in this paper.

A fourth insight in assessing these alternative analyses comes from examining the finance of “forward” contracts. A forward contract is an agreement in which persons agree to buy or sell a particular item at a specified time in the future at a price (the delivery price) specified when the contract is formed. One can derive the delivery price in the forward contract such that a party would neither demand nor be required to pay additional consideration to enter into the forward contract. If there is no risk of non-performance by either party, the delivery price in a forward contract will equal the spot (current) price for the property subject to the forward contract, increased by hypothetical interest on that amount at the risk-free rate over the time when delivery is due.47

Escher and Krueger note absence of payment immediately upon breach can be conceptualized as causing the promisor and the promisee to have entered into a forward contract whose underlying asset is the claim against the promisor.48 We also can now identify one reason why Fisher and Romaine’s approach is incorrect—a concern as to which Escher and Krueger are not explicit. The default creates a forward contract with a principal that is not necessarily risk-free. The pricing contemplated by Fisher and Romaine requires there be no

46 It is assumed in this discussion that the item does not produce income, e.g., dividends, or suffer physical depreciation, over the time-period in question. Adjusting for that possibility makes the algebra more complex, without affecting the intuition.
47 See JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVE SECURITIES 51 (2d ed. 1993). The intuition is that if the delivery price for the forward contract were higher, then a firm that can borrow at the risk-free rate would immediately (i) buy the property at the spot price, (ii) fund the purchase with a loan at the risk-free rate, and (iii) enter into the forward contract, agreeing to sell the property at the time the contract matured—profiting at the time the contract matured equal to the difference between the delivery price and the spot price at the time the contract was entered into plus interest on that amount at the risk-free rate.
48 Escher & Krueger, supra note 32, at 14.
incremental increase in default risk arising from the duration of the forward contract.

A different error in Fisher and Romaine's approach is identified by Escher and Krueger. Without focusing on the allocation of value among constituencies, they assert the plaintiff needs compensation for "cost of carry." The focus on constituencies, referenced above, explains the second component of the problem with Fisher and Romaine's approach: if the plaintiff cannot sell the claim for its value, it can be frozen into an investment that shifts value to its creditors from its shareholders.

IV. SHIFTING VALUE AMONG CONSTITUENCIES – REJECTION OF KNOLL’S APPROACH

Although the principles articulated in the preceding Parts highlight concerns with prior analyses, it is helpful to provide numerical illustrations. Turning first to Knoll's analysis, it clearly is elegant. Yet his conclusion that prejudgment interest should be at the promisor's cost of funds is counterintuitive. Assume a firm is borrowing funds currently at a high annual rate of interest, for example, twenty-three percent (a rate used in an example below) and the firm is the promisee of a contractual obligation in breach. The promisee's current borrowing at twenty-three percent would seem to prove conclusively that the firm has uses for its money promising a return greater than twenty-three percent. Otherwise, it would not be borrowing at that rate.

A promisor ordinarily does not have a right to change unilaterally a promisee's portfolio of investments. If the promisee is entitled to the bargain it struck, the fact that the market as a whole properly prices the promisor's debt, and is willing to extend the promisor a loan on favorable terms, does not excuse substitution of assets. Consider, for example, a person who, thirty years before retirement, sought a higher-yield security as a retirement investment. The

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49 Id. at 10–11.
50 See supra note 39 and accompanying text.
51 There is some similarity between Knoll's approach and the facts of Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989). In Metropolitan Life, the holders of bonds claimed the issuer's engaging in a leveraged buyout, which increased the leverage of the issuer, thereby decreasing the value of the bonds, violated implied obligations to the bondholders. The bondholders were therefore seeking to prevent the issuer from changing the risk of debt claims against the issuer. The court granted summary judgment to the defendant on claims alleging breach of the implied covenant of good faith, frustration of purpose, unconscionability and a theory akin to breach of fiduciary duty. Id. at 1516, 1522, 1526.
investor might well find it cold comfort to learn, upon retirement, that the selected investment had been replaced thirty years ago with a lower-yield, albeit a properly priced, riskless security.\textsuperscript{52}

Selection of the constituencies for whose benefit a corporation is to be managed is a basic principle not emphasized in prior commentary on prejudgment interest. A corporation ordinarily is managed for the benefit of the shareholders, not for the benefit of its creditors or the firm as a whole.\textsuperscript{53} The last two sentences of Knoll’s discussion quoted above\textsuperscript{54} assert that a plaintiff is overcompensated by receiving prejudgment interest at its cost of funds, because other claimholders could be made better off. Knoll’s approach therefore countenances giving a promisor the power, by default, to reallocate value among its promisee’s corporate constituencies.

A few quantitative examples illustrate that Knoll’s approach sanctions allowing a promisor by breach to change the aggregate risk of the promisee’s assets, thereby reallocating value among the promisee’s shareholders and creditors, to the detriment of the shareholders. This discussion is premised on an understanding that prejudgment interest is designed to compensate the


\textsuperscript{53} This statement represents the traditional understanding of the role of directors and officers. E.g., Richard A. Booth, Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty), 53 Bus. Law. 429, 430 (1998); Alon Chaver \& Jesse M. Fried, Managers’ Fiduciary Duty upon the Firm’s Insolvency: Accounting for Performance Creditors, 55 Vand. L. Rev. 1813, 1814 (2002); Thomas A. Smith, The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty, 98 Mich. L. Rev. 214, 214 (1999) (“Now the orthodox view among corporate law scholars is that the corporate fiduciary duty is a norm that requires firm managers to ‘maximize shareholder value.’ ”); see 3 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 849 (2002 rev. vol.) (rejecting a general duty of directors to creditors). This principle is not absolute, as managers may be authorized, although generally not required, to consider the impact of corporate actions on other constituencies. Cf. Booth, supra, at 432–33 (citing very limited authority for an obligation to consider interests of other constituencies). Insolvency or distress short of insolvency can affect the constituencies fiduciary duties require be considered. E.g., Credit Lyonnais Bank Nederland v. Pathe Communications Corp., Civil Action No. 12150, 1991 Del. Ch. LEXIS 215 (Dec. 30, 1991); Laura Lin, Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors, 46 Vand. L. Rev. 1485 (1993).

\textsuperscript{54} See supra text accompanying note 39.
plaintiff, as opposed to some other alternative, e.g., punishing the defendant or creating incentives for settlement, and that the claim cannot be immediately sold on default, the latter assumption being reviewed below.\textsuperscript{55} Lastly, to avoid distractions presented by the process of enforcing a judgment, it is assumed payments are made when judgment is entered, to the extent the defendant has the required funds.

Consider first a simplified example that assumes a risk-free rate of zero:

\textit{Example 1:} Assume a breach of contract at \textit{Time 0}. The promisor can borrow at the risk-free rate, zero.\textsuperscript{56} At \textit{Time 0}, the promisee \( P \) requires $9.50 to cover the breached obligation. A lender funds that transaction; the lender is to be repaid at \textit{Time 1}, the time when judgment is entered.

There is a risk \( P \) will not have sufficient assets to repay the loan, so the lender requires that \( P \) agree to pay the lender something more than $9.50 at some future time. To simplify the illustration further, assume it is known the lender will be either paid in full or, with a ten percent probability, the promisee \( P \) becomes insolvent, and the lender recovers fifty percent of what it is due.

The lender will require \( P \) promise to pay $10 at \textit{Time 1}, which results in the expected value of the lender’s claim being $9.50. The principal amount of the claim \( P \) has against the promisor is $9.50. The prejudgment interest necessary to make \( P \) whole can be easily calculated. In the nine times out of ten that \( P \) will not be in default at \textit{Time 1}, the equity is valuable. \( P \) needs to receive $10 from the original promisor – to fund the $10 payment to the lender – if \( P \) is to be made whole.

Even if there is no risk the original promisor will become insolvent, the claim against the original promisor is unconditional, and the risk-free rate is zero, then the original promisor still must agree to pay interest of $0.50 (5.3%).

\textsuperscript{55} See infra Part VI.

\textsuperscript{56} The example contemplates a party that can borrow at the risk-free rate not fulfilling its contractual obligation. That is not inherently inconsistent. Obligations of the federal government, for example, are considered riskless, in the sense of the promisor having assets sufficient to discharge the obligations being assumed, although the federal government does not necessarily perform its contractual obligations, and a promisee may therefore need to sue the federal government. \textit{E.g.}, Mobil Oil Exploration & Producing Southeast, Inc. v. United States, 530 U.S. 604 (2000) (granting restitution of funds paid the federal government for oil exploration lease contracts); United States v. Winstar Corp., 518 U.S. 839 (1996) (obligations arising from private acquisitions of failing thrift institutions).
This is the same amount $P$ pays the lender that funds the covering transaction, in order to compensate $P$ fully. That is the case, even though the original promisor can borrow at the risk-free rate (in this case, zero).

Of course, in this example, one time out of ten, the additional $0.50 inures to the benefit of $P$'s creditors.

A second, more detailed example demonstrates that the result does not depend on the risk-free rate being zero. It also provides more detail of the impact of reallocation of value among security-holders and creditors:

*Example 2:* On January 1 of year 1, $A$ has $100 and no liabilities. $A$ borrows $200 from a bank, *Bank 1*, promising to repay the funds on January 1 of year 2. $A$ agrees with *Bank 1* that $A$ will make two $100 investments on January 1 of year 1, one in $S_1$ and one in $S_2$. Each investment will have a 50% probability of paying $210 on January 1 of year 2 and a 50% probability of paying nothing. The contingencies are independent of each other. The risk-free rate of interest is 5% per year. Each of $S_1$ and $S_2$ is "riskless," in the sense of being assured of having assets sufficient to discharge its obligations. Therefore, each investment can be made on January 1 of year 1 for $100.\footnote{That is because the present value, as of January 1 of year 1, of $210 to be received on January 1 of year 2 is $200. Thus, the present value of each investment on January 1 of year 1 is $0.5 \times 200$, or $100.}

In addition, $A$ agrees with *Bank 1* that $A$ will invest $100 in a riskless asset, paying 5% per year, maturing on January 1 of year 2.

On January 1 of year 1, immediately after $A$ makes payments to $S_1$ and $S_2$, $S_2$ repudiates. $A$ borrows an additional $100 from a second bank, *Bank 2*, and covers the repudiated promise.

At the time *Bank 1* is considering the possibility of extending credit, it is likely to price the loan based on three possible outcomes on January 1 of year 2.\footnote{*Bank 1* might also consider the possibility $S_1$ or $S_2$ would breach. As shown below, see infra note 62, a breach and cover shifts value to *Bank 1*, by decreasing the risk of an investment in $A$, through inclusion of additional risk-free assets. However, *Bank 1* is not likely to reduce the rate $A$ is obligated to pay, because the bank is unlikely to be able to assess the likelihood of that breach.}

a. *probability: 0.25:* The investments in $S_1$ and $S_2$ are successful. $A$ has received an aggregate of $420 from $S_1$ and $S_2$, and $105 from the
proceeds of the riskless investment of $100 for one year. A also has a liability to Bank 1 of $200 plus interest.

b. probability: 0.5: One risky investment is successful and one is not. A has received $210 from either S1 or S2. A also has received $105 from the proceeds of the riskless investment of $100 for one year. In addition, A has a liability to Bank 1 of $200 plus interest.

c. probability: 0.25: Neither the investment in S1 nor that in S2 is successful. A has assets of $105 and a liability to Bank 1 of $200 plus interest.

A little algebra yields Bank 1 will charge interest of 22.5%.

The discussion can now proceed to the consequences of S2's breach. The point is to demonstrate that if A immediately covers and A has a higher cost of borrowing than S2, obligating S2 (the promisor) to pay prejudgment interest at S2's cost of funds, as opposed to A's (the promisee’s) cost of funds, undercompensates A, shifting value to its creditors.

Let us first assume A funds its covering transaction with unsecured debt, an assumption that will be examined below. Also assume it will take a year to litigate the dispute between A and S2, there are no costs of litigation, and S2 is obligated to pay interest at its cost of funds – the risk-free rate. A borrows funds from Bank 2 to finance a covering transaction and covers with the proceeds. Bank 2 may charge A a lower interest rate than Bank 1 did, because A’s portfolio of assets, which now includes the right to receive compensation from S2, has declined in risk. It will be costly for A to benefit fully from the lower rate of interest, because that would require Bank 2 to become fully informed of the likelihood that A has a valid claim against S2. Yet even if Bank 2 is fully

59 The rate can be computed as follows: Assume the interest rate is not more than 57.5%, or $115 on the $200 loan. In that case, Bank 1 will receive principal plus interest in full, as long as at least one of the investments in S1 and S2 is successful. (That is because A will have assets of at least $315 and liabilities of $200 plus interest. Thus, Bank 1 can receive up to $115, or 57.5%, in interest.) Thus, in exchange for $200, the bank will receive in one year:

(i) with a probability of 75%, $200 plus $i \times 200$, where $i$ represents the interest rate; or
(ii) with a probability of 25%, $105.

Each of these payments will be received in one year, and they therefore have to be discounted by a factor of 1/1.05, or 0.952. Thus, $200 = 0.952 (150 + i \times 150 + 26.25)$; or $i = 22.5%$.

60 See infra, Part VI.
informed and reduces the interest rate to the correct rate, in this case, 17.33% per annum.\(^6\) the value of A’s equity decreases.

That can be illustrated as follows: before the default, the aggregate value of A’s equity and the value of Bank 1’s loan was $300. S2’s repudiation has substituted a claim against S2 at the risk-free rate for its promised performance. By substituting something of equivalent value, the aggregate value of A’s equity and the value of Bank 1’s loan must remain unchanged at $300. Similarly, if the loan from Bank 2 is properly priced, the loan will not decrease the aggregate value of A’s equity and Bank 1’s claim. So, after the loan from Bank 2, the aggregate value of A’s equity and the rights of Bank 1 in A remains $300 – the value before S2’s default. If the interest rate is properly set in this kind of stylized illustration, it should neither increase nor decrease the value of all interests in A for A to borrow funds. A decrease in aggregate value of all rights in A (A’s shareholders and creditors) would mean value had been “lost” somewhere in the transaction, and an increase would mean value had been created.

Although the aggregate value of the rights of Bank 1 in A and A’s equity has not changed, S2’s default has shifted value from A’s equity to Bank 1. After that default and A’s cover, Bank 1’s loan has a present value, on January 1 of year 1, of $209 (increasing from $200), and there has been a corresponding decrease in

\(^6\) The rationale for that conclusion is as follows: after that covering transaction, A now has assets comprising: (i) a $100 investment in S1; (ii) a $100 covering investment in a third party; (iii) a $100 riskless investment, with 5% interest, and payable in one year; and (iv) the right to receive compensation of $105 in one year from S2.

At that time, A has liabilities in an aggregate face amount of $300, $200 owed to Bank 1 and $100 owed to Bank 2. One year later, Bank 2 will be paid in full if either the investment in S1 or the investment covering S2’s breach is successful (pays $105). If one of those two investments is successful, A will have assets at that time of $210 (the proceeds of one successful investment) + $105 (the return on the riskless investment) + $105 (payment from S2 for breach), or $420. It will have liabilities of $245 to Bank 1 ($200 plus 22.5% interest) and $100 plus interest to Bank 2. As long as the interest owed to Bank 2 is less than $420-$245-$100, or $75 (75%), then Bank 2 will be paid in full if at least one of the two investments is successful.

If neither investment is successful, in one year, A will have assets of $210 (the return on the riskless investment plus the payment from S2 for breach), and liabilities of $245 to Bank 1, as well as its liability to Bank 2. That Bank 2 will charge 17.33% (a rate less than the 75% assumed in the preceding paragraph) can be confirmed by noting that, if it charges that rate, the expected future value to be received by Bank 2 in one year is $105, computed as follows:

\[
105 = 0.75 \left[ 117.33 \right] + 0.25 \left[ \frac{117.33}{245 + 117.33} \right] 210
\]
the present value of A’s equity, as of January 1, year 1, to $91 (from $100).\textsuperscript{62} If transaction costs prevented Bank 2’s becoming fully informed, and Bank 2 did not fully account for the increased risk of a loan, there would be an additional adverse impact on A’s equityholders.

Only increasing the interest rate paid by S2 to the rate being paid to Bank 2 would result in an increase in the value retained by A sufficient to preserve A’s pre-repudiation value of $100. Although the arithmetic to determine the rate is somewhat tedious, if the prejudgment interest rate paid by S2 is 16.26%, which is well above the hypothesized risk-free rate, Bank 2, if fully informed, will charge a rate of 16.26%. In that case, the value of A’s equity on January 1 of year 1 remains $100 after the default by S2 and A’s cover.\textsuperscript{63}

These simple examples illustrate that, if the promisee’s cost of borrowing in covering the transaction in default is higher than the promisor’s cost of funds, payment of prejudgment interest at a defaulting promisor’s cost of funds can undercompensate the promisee by shifting value from the promisee to its creditors. That can happen even if a third party funding a covering transaction is perfectly (and costlessly) informed about the value of the claim against the promisor. If the third party funding a covering transaction is not so informed, the adverse impact on the promisee’s equity may be even greater.

V. DECOMPOSING THE PROMISOR’S COST OF FUNDS

A. Decomposing the Cost of Funds

The second insight that raises concerns with Knoll’s approach, and the earlier analysis of Patell et al., which concludes a transferable claim should bear

\textsuperscript{62} That can be confirmed as follows: The calculations in note 61, supra, demonstrate the creditors will be paid in full unless both investments are unsuccessful. If both investments are unsuccessful, then the value of A’s equity (A’s value) will be zero. There is a 25% chance both investments will be unsuccessful. The value of A can therefore be computed by reference to the 25% probability that both investments will be successful (giving A gross assets of $210 + $210 + $105 + $105, in the order the assets are listed in note 61, supra, or $630) and the 75% probability that only one investment will be successful (giving A gross assets of $420). That conclusion produces a $91 valuation of A (rounded):

\[
\left\{0.25 \left[630 - 245 - 117\right] + 0.5 \left[420 - 245 - 117\right]\right\} / 1.05
\]

\textsuperscript{63} \{0.25 \left[641.26 - 245 -116.26\right] + 0.5 \left[431.26 - 245 - 116.26\right]\} / 1.05 = 100
interest at the defendant’s cost of funds, is the possibility of double-counting the risk of an investment in the promisor, if there is a possibility the promisor may become insolvent. That can be illustrated with a third example:

Example 3: B and C enter into a contract, in which B delivers property with a value of $100 to C at Time 0. C is to render performance at Time 1. There is a ninety percent chance C will be solvent at Time 1, and there is a ten percent chance C will have assets at that time sufficient to discharge one-half its liabilities. The risk-free rate of return is zero.

For B to enter into this contract, the value of the promised performance at Time 1 must be $105.26.

Consider the following three possible subsequent developments:

(i) C renders performance worth $105.26 at Time 1.

(ii) C defaults shortly before Time 1, e.g., breaches a covenant, accelerating payment, at a time when it is not yet clear whether C will be able to discharge all its liabilities at Time 1, and B sues, and, when the lawsuit is initiated, there has not yet been any change in the likelihood C will be insolvent at Time 1.

(iii) C defaults at Time 1.

The question is whether the value of B’s claim — the amount owed B at Time 1 in each of these three cases — should be the same. If the claim bears interest based on C’s cost of funds, in circumstance (ii), B’s claim, at Time 1, after adding prejudgment interest, would be $110.80. In that case, if C were solvent at Time 1, B would be paid the risk premium twice.

The question is then whether that is a sensible result. It is not. If the law followed that approach, at the time the contract was initially formed, the parties could estimate the likelihood there would be a default at or before Time 1. They could then, at the time of contract formation, try to adjust downward the value

\[ (0.9 \times 105.26) + (0.1 \times 105.26 / 2) = 100 \]
of C's promised performance, to reflect the possibility of default before full maturation of the possibility of insolvency and a resulting increase – the value received by B through prejudgment interest. The problem with that approach is that it is not practicable. The promisee is unlikely to be able to ascribe a value to that possibility.

In sum, providing for prejudgment interest based on the promisor's cost of funds at the time of default produces hyper-complexity in pricing default at the contract formation stage. That is not a desirable result, and is one that is likely not to reflect the basis on which the parties actually price transactions.

These stylized illustrations are being provided without incorporating provisions of bankruptcy law, which ultimately reallocate value. For example, the bankruptcy code limits a real property lessor's claims. However, the ability to avoid payments on antecedent debts merits mention, and reinforces the notion that prejudgment interest should not incorporate the promisee's short-term default risk. Where a payment is made on an antecedent debt within ninety days of the filing of a bankruptcy petition, subject to certain exceptions, the trustee is permitted to avoid the payment. In Example 3, if performance is rendered by C, B's ability to retain payment in full nevertheless remains subject to being reclaimed in the short-term. One might more generally state that the promisee has, at Time 0, priced-in the short-term default risk of the promisor. Only an increase in that default risk, arising from postponement of payment following litigation, would be required to reflect what is the likely computational basis of the initial bargain.

For example, litigation of a claim might take three years. At the time performance was due, lenders to the promisor might require a 3% premium for the risk associated with a short-term, e.g., sixty day, loan and a 5% premium for risk associated with a three-year loan. If, by litigating, the promisor postpones payment for three years, the promisee has assumed an additional risk, arising from the postponement of payment. That is a second-order adjustment to the risk of contracting, and is unlikely to be reflected in initial pricing. For

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67 11 U.S.C. § 502(b)(6) (2000) (limiting claim for termination of a lease of real property to the greater of rent for one year or fifteen percent of the remaining term, up to three years).
68 11 U.S.C. § 547(b)-(c) (2000) (subject to increase where the creditor is an insider).
69 Cf. Knoll, supra note 2, at 320 (noting, "[T]he more quickly a bond is repaid, the greater the likelihood of full repayment.").
70 At the time of contracting, a "first-order" effect on the value the promisee expects arises from the probability the promisor will be insolvent at the time performance is due. This possible increase in default risk, arising from litigation allowing postponement of performance, is a
prejudgment interest to be truly compensatory, in the illustration, only the additional two percentage point (5% - 3%) increase in default premium should be reflected in prejudgment interest. For this reason, one can in part reject the view expressed by Keir and Keir, that prejudgment interest reflecting default risk by the promisor should not be provided where the underlying claim is legal.\textsuperscript{71}

This factor is one that complicates relative rights among contract and tort claimants. Although in some cases a tort claimant may have a pre-existing contractual relationship whose pricing could reflect the possibility of default, e.g., claims of conversion against a bailee, a tort claimant frequently will not have had the opportunity to have incorporated the tortfeasor’s default rate.\textsuperscript{72} There are complex policy choices associated with allocation of default risk among tort claimants and contract claimants. If one were of the view that, as the tort claimant was not previously compensated for any default risk of the promisor, and therefore the entire default risk should be reflected in its prejudgment interest, that would reallocate value among tort and contract claimants. The reallocation could be dramatic where the tortfeasor was in dire financial circumstances.

B. Short-Term Rate vs. Extendable Rate

In identifying the promisee’s cost of funds for purposes of determining the fully compensatory prejudgment interest, the rate for a traditional term loan might not be the proper reference. Knoll argues for referencing the short-term rate.\textsuperscript{73} He asserts referencing a long-term rate will inhibit settlement, as a variation in interest rate will allocate to one party or the other a preference to postpone judgment.\textsuperscript{74} He also asserts that the normal reason why long-term interest rates exceed those of short-term rates is that there is a liquidity preference.\textsuperscript{75} He then asserts, “[b]ecause prejudgment interest is calculated ex post, there is no risk that interest rates will later change. Accordingly, prejudgment interest should be calculated using a very short-term rate, which does not contain a premium for interest rate risk.”\textsuperscript{76}
That argument is difficult to follow. If we conceive of prejudgment interest as reflecting a forced investment and long-term rates being higher to account for liquidity preference, the fact that interest rates can be computed ex post does not eliminate the fact that this forced investment has deprived the promisee of liquidity to which it was entitled. The fact that there was a judgment, on which the interest is computed, makes clear that the promisee was, in fact, entitled to the liquidity.

In some ways this looks like a short-term loan that is extendable — a loan whose maturity the promisor has the option to extend (which can alternatively be conceived of as a long-term loan subject to prepayment without penalty). Such an option is valuable, and would produce a higher interest rate than a short-term loan with a fixed maturity date.

VI. SALE OF THE CLAIM — FUNDING COVER WITH A SECURED LOAN

The preceding examples compute the impact of breach on the assumption that a covering transaction is funded with unsecured debt. Additional nuance is provided to the analysis by considering the possibility that the promisee may either sell the claim or fund a covering transaction with debt secured by the claim.

If the promisee could sell the claim without transaction costs, the promisee would be fully compensated were the claim to bear prejudgment interest at a rate reflecting the increased default risk arising from postponement of payment and the risk-free rate for a loan over the period until judgment.\footnote{Cf. Patell et al., supra note 29, at 342 (referencing claim bearing interest at the defendant's debt rate).} Omitted are (i) any factor reflecting the promisee's cost of funds and (ii) the promisor's short-term default risk, which is best viewed as already being priced into the amount of the claim. The promisee's cost of funds is not relevant, because the ability to resell the claim freely would allow it to realize its expected value independent of the promisee's default risk (its cost of funds). Part V develops the reasons for omission of the promisor's short-term default risk.

Limiting prejudgment interest to an amount based on the risk-free rate plus the increased default risk arising from postponement of payment provides properly computed prejudgment reflecting the claim as a liquid asset. Whether that model is accurate depends on the kind of claim in question. Pertinent factors include whether transaction costs would predominate in any attempt to
sell the claim to a third party and whether the jurisdiction makes sale of the claim unlawful, e.g., as champertous. For example, UCC § 9-406(f)\(^{78}\) renders ineffective other statutory provisions or regulations that would prohibit the sale of a claim that is an "account,"\(^{79}\) although perhaps the most prominent jurisdiction for this purpose, New York, modified Article 9 in enactment to eliminate this provision.\(^{80}\)

Whether it is desirable for a jurisdiction to seek to provide different levels of prejudgment interest based on the liquidity of the claim depends on empirical evidence, such as the relative frequencies and amounts of the different types of claims (liquid or illiquid) and the relative importance of transaction costs. In the absence of that empirical evidence, no recommendation is made here between two choices: (i) disregarding the possible sale of the claim and (ii) providing prejudgment interest varying depending on the nature of the claim. Judgment, albeit one without empirical backing, suggests that one can reject, however, as being the best estimate of properly compensatory prejudgment interest, providing prejudgment interest in all cases based on an assumption of free resale of the claim. It does not seem likely that circumstance predominates.

One may also consider whether the promisee’s cost of funds should be based on a secured loan. One might consider either a secured loan having only the claim as collateral or a secured loan additionally having other assets as collateral. As to the latter case, a decrease in the promisee’s cost of funds arising from creation of a security interest in the promisee’s assets other than the claim itself can be rejected out of hand. Funding a covering transaction with that collateral represents a decrease in the promisee’s liquidity that likely was not bargained-for. Similar to the discussion above,\(^{81}\) it is possible for parties, at the time of contracting, to have contemplated a possibility such as the promisee

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\(^{79}\) The term "account" is defined in U.C.C. § 9-102(2), as "a right to payment of a monetary obligation, whether or not earned by performance" in connection with eight enumerated circumstances, e.g., "for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of." One of the exclusions concerns commercial tort claims. Id. Rights under other contracts would be "general intangibles." U.C.C. § 9-102(42). The abrogation of existing law concerning assignments of general intangibles is more limited. See U.C.C. § 9-408(c), (d).

\(^{80}\) N.Y. U.C.C. § 9-406 (McKinney 2002). See generally Bluebird Partners, L.P. v. First Fid. Bank, 731 N.E.2d 581, 587 (N.Y. 2000) ("[I]n order to constitute champertous conduct in the acquisition of rights that would then be nullified and to resolve the question at issue, the foundational intent to sue on that claim must at least have been the primary purpose for, if not the sole motivation behind, entering into the transaction.").

\(^{81}\) See supra, Part V.
funding a covering transaction with a loan secured in all the promisee's assets. However, it seems unlikely that would be the basis on which a transaction ordinarily would be priced. The promisee would need to charge more for that potential loss of liquidity. However, because the loss of liquidity would only arise after the other party's breach, it would be difficult for the promisee to price it.

As to the former case, involving a secured loan having only the claim as collateral, if that claim could practicably be used to decrease the promisee's cost of funds, that lower rate should be reflected in ascertaining fully compensatory the prejudgment interest. If secured credit worked perfectly, for example, under an arrangement involving a nonrecourse loan, properly compensatory prejudgment interest in those cases would be similar to that where the promisee had the ability to sell the claim outright. And Article 9 also has similar limits on the extent to which other law may prevent the creation of a security interest in a claim. Of course, for various reasons, secured credit does not work perfectly, and a secured loan to the promisee might bear interest at a rate above that on the underlying claim. And as in the case with an outright sale of the claim, intuition, albeit one not reinforced with empirical evidence, suggests the transaction costs - particularly the cost of obtaining information concerning possible defenses to the claim - frequently would substantially inhibit the efficient funding of a covering transaction with a loan secured by the claim in default.

VII. CONCLUSION

The legal literature examining computation of fully compensatory prejudgment interest provides persuasive rationales that nevertheless reach contradictory conclusions. Focusing on contract claims between large businesses, this paper primarily develops two principles allowing selection among those analyses.


83 See generally, e.g., 7 COLLIER ON BANKRUPTCY ¶ 1129.05[2][c] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004) (noting “a plan may be confirmed against a secured creditor's wishes if the plan provides ‘for the realization by such holders of the indubitable equivalent of such claims.’”) (quoting 11 U.S.C. § 1129(b)(2)(A)(iii) (2000))).
First, prejudgment interest is not fully compensatory if it allows a promisor, in breach, to reallocate value among the promisee and the promisee’s creditors. For this reason, one can reject the argument that prejudgment interest at the promisor’s cost of funds is necessarily fully compensatory. However, providing prejudgment interest necessary to keep the promisee whole may result in additional value being transferred from the promisor to the promisee’s creditors, in order to assure the promisee itself is made whole.

Second, prejudgment interest that reflects the promisor’s short-term default risk, at the time performance becomes due, likely produces double-counting in prejudgment interest for contract claimants. The risk of the promisor’s insolvency likely will have already been priced-in, but not the partially-offsetting possibility that the promisor will default, the promisee will bring a lawsuit and, in the lawsuit, be able to increase its award based on the promisor’s risk premium at the time of default (or lawsuit initiation, if that is when prejudgment interest starts in the particular jurisdiction). It likely will be too complex for the promisee to ascribe a value to that partially-offsetting possibility.

Applying these principles yields the conclusion that fully compensatory prejudgment interest would be based on (i) any incremental increase in default risk arising from the promisor’s postponement of payment by litigation and (ii) the promisee’s cost of funds (subject to additional detail-intensive nuance depending on whether the claim could either be sold or be the subject of a valid security interest, and on the transaction costs associated with either). This analysis allows a more thoughtful policy choice in the setting of prejudgment interest.