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NOTE

Federal Common Law's Long Shadow: Shedding Light on State Law Rights to Postpetition Default Interest

Evan Miller[*]

I. INTRODUCTION

Historically, the law imposed harsh penalties on debtors who could not meet their obligations.[1] One regime dismembered the debtor's body and proportionally distributed it to creditors.[2] Rejecting these draconian penalties, the United States Constitution empowered Congress to enact federal bankruptcy legislation.[3] Bankruptcy laws in the United States helped the "unfortunate" debtor get a fresh start while providing creditors with "prompt and effectual" administration of the debtor's unmet obligations.[4] In order to accomplish these policy objectives, Congress granted equitable powers to bankruptcy courts.[5] These powers allow bankruptcy courts to occasionally adjust parties' rights under non-

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[1] 1 COLLIER ON BANKRUPTCY ¶ 20.01 (1) (Richard Levin and Henry J. Sommer eds., 16th ed. 2022).

[2] *Id.* Italy, from where the United States took the term "bankruptcy," would allow debtors to make nude proclamations in order to forgo criminal prosecution. *Id.*

[3] U.S. CONST. art. I, § 8, cl. 3 (interstate commerce); U.S. CONST. art. I, § 8, cl. 4 (bankruptcy). Uniform bankruptcy law appeared to be a strong solution to counter fraud and mitigate difficulties arising from various property rights in different states. COLLIER, *supra* note 1, ¶ 20.01 (1).

[4] 1 COLLIER, *supra* note 1, at ¶ 1.01 (1).

[5] 11 U.S.C. § 105(a); *see generally* Pepper v. Litton, 308 U.S. 295, 303–04 (1939).

bankruptcy law and fairly distribute the debtor's assets among creditors.[6] The process of balancing equities between the debtor and her creditors, as well as between creditors, is a central inquiry of bankruptcy law analysis.[7]

Unfortunately, the equitable nature of bankruptcy courts catalyzed an unpredictable process—different federal bankruptcy courts faced similar fact patterns but reached different outcomes each time based on the equities of a case.[8] Despite the Supreme Court's disfavor of "federal common law,"[9] the federal common law casts a shadow over bankruptcy law.[10] Of particular concern, bankruptcy courts patched together a federal common law governing interest maturing after the debtor files a bankruptcy petition, a claim referred to as postpetition default interest.[11] Section 506(b) of the Bankruptcy Code governs postpetition default interest.[12] In relevant part, § 506(b) states:

> To the extent that an allowed secured claim is secured by property the value of which, . . . is greater than the amount of such claim, there shall be allowed . . . *interest on such claim*, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.[13]

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[6] *In re* Hollstrom, 133 B.R. 535, 541 (Bankr. D. Colo. 1991) ("Bankruptcy essentially is, after all, a process of equitably adjusting contending creditors' claims and rights, and effectuating a fair distribution of a debtor's property among those creditors.").

[7] *See Pepper*, 308 U.S. at 304–05. Balancing equities among creditors is important because there are often inadequate funds in the bankruptcy estate, and payment of some creditors may disadvantage other creditors. *E.g.*, Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 164 (1946) ("To allow a secured creditor interest where his security was worth less than the value of his debt was thought to be inequitable to unsecured creditors.").

[8] *Compare In re* Loveridge Mach. & Tool Co., Inc., 36 B.R. 159, 163–65 (Bankr. D. Utah 1983) (holding that 506(b) required the contract rate of interest), *with In re* W.S. Sheppley & Co., 62 B.R. 271, 278 (Bankr. N.D. Iowa 1986) (permitting modification of postpetition default interest on the equities of the case).

[9] *See* Rodriguez v. Fed. Deposit Ins. Corp., 140 S. Ct. 713, 717 (2020).

[10] *See* Mitchell P. Reich, *A Swan Song for Federal Common Lawmaking in Bankruptcy Courts*, 39 AM. BANKR. INST. J., 20, 75 (2020).

[11] *In re W.S. Sheppley*, 62 B.R. at 275; *see also* Matter of Terry Ltd. P'ship, 27 F.3d 241, 242 (7th Cir. 1994) ("What emerges from the post-Ron Pair decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations.").

[12] *Compare In re* Sundale, Ltd., 410 B.R. 101, 106 (Bankr. S.D. Fla. 2009) (holding that the bankruptcy court was bound to enforce the default interest rate under 506(b)) *with In re* Consol. Properties Ltd. P'ship, 152 B.R. 452, 455 (Bankr. D. Md. 1993) (holding that the bankruptcy court was not required to enforce the default interest rate under 506(b)).

[13] 11 U.S.C. § 506(b) (emphasis added).

A recent case, *In re Family Pharmacy*, highlighted the issues plaguing § 506(b).[14] The bankruptcy court applied equities to a claim for postpetition default interest, which the appellate court condemned on review, breaking from the majority position on postpetition default interest.[15] This Note argues that *Family Pharmacy* was correct in its analysis of equitable principles but fell short in its general analysis of claims for postpetition default interest.[16] Part II examines the history of bankruptcy law and § 506(b), which illustrate why the dispute in *Family Pharmacy* occurred in the first place. Part III takes an in-depth look at *Family Pharmacy*, *Law v. Siegel*, and *Rodriguez v. FDIC*, recent controversies that bring § 506(b) to center stage in the grand bankruptcy drama. Finally, Part IV offers a state law solution to dispel the shadow of federal common law obscuring § 506(b) and the future of postpetition default interest.

II. LEGAL BACKGROUND

A debtor initiates bankruptcy proceedings by filing a petition in bankruptcy court.[17] This petition creates the debtor's "estate," comprised of her assets, from which the creditors may satisfy their claims.[18] When the debtor files a bankruptcy petition, creditors' activities against debtors must cease.[19] In lieu of seeking payment through typical channels of collection, creditors file a proof of claim with the bankruptcy court to collect from the debtor.[20] Any right to payment arises under the substantive law that formed the obligation between the debtor and the

[14] *In re* Fam. Pharmacy, Inc., 614 B.R. 58 (B.A.P. 8th Cir. 2020).

[15] *Id*. at 65.

[16] *See infra* notes 172–89.

[17] 11 U.S.C. § 301. Bankruptcy petitions may also be filed against a debtor by three or more of the debtor's creditors. *Id.* § 303.

[18] 1 COLLIER, *supra* note 1, at ¶ 1.03 (1).

[19] 11 U.S.C. § 362. This provision of the bankruptcy code is enforced strictly by courts. *See, e.g.*, Matter of Okedokun, 968 F.3d 378, 387 (5th Cir. 2020) (purchasers of foreclosed property violated automatic stay by purchasing property of debtor who had filed bankruptcy three hours earlier, even though purchasers did not have knowledge of the bankruptcy filing). In certain circumstances, creditors may petition the bankruptcy court to allow creditor's activities to proceed against the debtor. 11 U.S.C. § 362(d).

[20] 11 U.S.C. § 101(5)(A) (listing the different "rights of payment" for which a creditor may file a proof of claim). The centralization of the bankruptcy process protects against the "destructive effects and inefficiencies of individualized action." Bruce Grohsgal, *The Alteration of Ex Ante Agreements by the Bankruptcy Code*, 95 AM. BANKR. L.J. 713, 715 (2021).

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creditor.[21] Bankruptcy courts apply the Bankruptcy Code to disburse the assets of the bankruptcy estate to the creditors.[22]

The Code does not allow creditors to collect unmatured interest after the debtor files the bankruptcy petition.[23] However, the Code provides an exception for oversecured creditors—i.e., creditors whose liens on a debtor's property are lesser in value than the debtor's property as a whole.[24] Section 506(b) of the Code overrides the statutory prohibition against unmatured interest to allow oversecured creditors to collect unmatured interest on their claims after the debtor files for bankruptcy.[25] Bankruptcy courts generally agree that § 506(b) allows creditors to collect simple interest at the contract rate, but they have approached default interest with greater trepidation.[26] The history of bankruptcy law lays a foundation for contemporary cases that dealt with postpetition default interest and federal common law.

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[21] Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 450 (2007). State law typically governs these entitlements. COLLIER, *supra* note 1, at ¶ 1.03 (2). Any claim is enforceable against the debtor unless applicable law provides otherwise. 11 U.S.C. § 502(b)(1).

[22] 1 COLLIER, *supra* note 1, at ¶ 1.03(3)(5). The Code provides priorities, according to which the estate is distributed. *Id.* The Bankruptcy Code modifies some creditor's rights to collect on its claims in bankruptcy. *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198, 211–12 (1983) (holding that the IRS, as a secured creditor, could not repossess the debtor's property under pre-bankruptcy rights, but could exercise other rights as enumerated by the Bankruptcy Code).

[23] 11 U.S.C. § 502(b)(2). The Code does not allow unmatured interest because computation of the interest becomes difficult after filing, which tends to slow the court's efficacious administration of the estate. 4 COLLIER ON BANKRUPTCY ¶ 502.03 (3) (15th ed. 2022). *See also In re* Hanna, 872 F.2d 829, 830 (8th Cir. 1989) ("The general rule 'disallowing' the payment of unmatured interest out of the assets of the bankruptcy estate is a rule of administrative convenience and fairness to all creditors.").

[24] 1 COLLIER, *supra* note 1, at ¶ 1.03(4). Secured creditors generally receive better treatment than unsecured creditors. 4 COLLIER, *supra* note 23, at ¶ 506.02. This unequal treatment persists to preserve the benefit of the bargain that secured creditors made when financing the debtor in exchange for a lien on the debtor's property. *Id.* Congress could have treated secured creditors the same as unsecured creditors but chose not to do so. *Id.*; *but see* Grohsgal, *supra* note 20, at 715 (arguing that the Bankruptcy Code modifies numerous ex-ante contracts to achieve the goals of bankruptcy policy).

[25] 11 U.S.C. § 506(b).

[26] *Compare In re* Loveridge Mach. & Tool Co., Inc., 36 B.R. 159, 165 (Bankr. D. Utah 1983) (collecting cases supporting the enforcement of the contract rate of interest in bankruptcy) *with In re* W.S. Sheppley & Co., 62 B.R. 271, 274 (Bankr. N.D. Iowa 1986) (struggling to understand an increase in the interest rate after the debtor's default).

Miller: Federal Common Law's Long Shadow: Shedding Light on State Law Rig

A. American Bankruptcy History

The constitutional mandate of uniformity in bankruptcy law across the several states faced early challenges.[27] After several unsuccessful iterations,[28] Congress passed the Bankruptcy Act in 1898.[29] The Bankruptcy Act provided relief to the "meritorious and unfortunate debtor,"[30] by requiring an exchange of the debtor's assets for a fresh start unimpaired by creditors.[31] In an early test of the Act's uniformity, a New York bank challenged the Act, claiming that it was unconstitutional.[32] The bank argued that the Act lacked uniformity because it allowed state provisions to determine the extent to which some assets entered the bankruptcy estate.[33] The Supreme Court upheld the Act, concluding that bankruptcy laws are "geographically uniform,"[34] and that Congress was well within its rights to recognize certain local laws dealing with state property rights.[35] Despite the bank's pleas to the contrary, bankruptcy courts could reach only property available to them through non-bankruptcy law.[36] The respect accorded to state law entitlements might produce different outcomes in different states, but those differences are acceptable because courts were normally confined to non-bankruptcy law when satisfying creditors' claims.[37] Unlike other courts, however,

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[27] *See generally* 1 COLLIER, *supra* note 1, at ¶ 20.01 (2)(a)–(c) (history of bankruptcy law). The Constitution requires bankruptcy law to be uniform. U.S. CONST. art. I, § 8, cl. 4.

[28] *See generally* 1 COLLIER, *supra* note 1, at ¶ 20.01(a)–(c).

[29] *Id.* at ¶ 20.01(2)(d).

[30] Hanover Nat. Bank v. Moyses, 186 U.S. 181, 185 (1902). The Supreme Court reiterated this policy principle on multiple occasions. Loc. Loan Co. v. Hunt, 292 U.S. 234, 244 (1934); Grogan v. Garner, 498 U.S. 279, 286 (1991); Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007); *id.* at 381 (Alito, J., dissenting).

[31] *See generally Hanover*, 186 U.S. at 188–89. The estate resulting from a bankruptcy petition creates a "common pool" from which creditors can satisfy their claims. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 864 n.34 (1982) (describing the common pool from which creditors satisfy their claims).

[32] *Hanover*, 186 U.S. at 183. Hannover Bank argued that Act did not give due process to debtors and was not actually "uniform" as required by the Constitution. *Id.* at 183.

[33] *Id*. At issue specifically in this case was the amount of exemptions under state law available to the debtor. *Id.* at 189–90.

[34] *Id.* at 188.

[35] *Id*. at 190.

[36] *See id.* 189–90.

[37] *See id.*

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Congress endowed bankruptcy courts with equitable powers.[38] These equitable powers were on a collision course with state law.[39]

The Bankruptcy Act established the equitable powers of bankruptcy courts.[40] Bankruptcy courts prioritize substance over form and prevent technicalities from thwarting justice.[41] In 1946, the Supreme Court explained the role of equitable powers and federal law in a trio of cases. In *American Surety Company of New York v. Sampsell*, the Court held that federal law—which allows courts to exercise equitable principles—provides the rule of decision in distributing assets of the bankrupt.[42] In *Heiser v. Woodruff*, the Court held that bankruptcy courts were not required to "adopt local rules of law in determining what claims are provable, or to be allowed."[43] And finally, in *Vanston Bondholders Committee v. Green*, the Court clarified that bankruptcy courts need not look to state laws to understand whether a claim is enforceable, but rather bankruptcy law alone is sufficient.[44] According to the Court, the congressional intent behind the Act licensed bankruptcy courts to use equitable principles to determine which claims should be allowed.[45] In the Court's view, "the touchstone of each decision on allowance of interest in bankruptcy . . . has been a balance of equities between creditor and creditor or between creditors and the debtor."[46] Justice Frankfurter argued in a concurring opinion that the first question to ask was whether the state law created an enforceable claim in general.[47] Only after understanding whether a claim exists at all, Justice Frankfurter contended, could a bankruptcy court begin its analysis of whether the claim should be allowed in bankruptcy proceedings.[48] Justice Frankfurter recognized that

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[38] Pepper v. Litton, 308 U.S. 295, 303 (1939).

[39] *See id.* 302–03 (holding that equitable principles allowed a bankruptcy court to subordinate ostensibly valid state court judgments).

[40] *Id.* at 303–04.

[41] *Id.* at 303. Congress codified the bankruptcy court's equitable powers in § 105(a) of the Bankruptcy Code: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. . . . [the court may], sua sponte, tak[e] any action or mak[e] any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process." 11 U.S.C. § 105(a).

[42] 327 U.S. 269, 272 (1946). The *Sampsell* Court asked whether "materialmen's liens" should be subordinated. *Id*. at 271.

[43] 327 U.S. 726, 732 (1946). At the same time, there must be "appropriate regard for rights acquired under state law." *Id.* at 732.

[44] 329 U.S. 156, 163 (1946). The Court need not look to the state laws to understand whether the claim was enforceable, only to bankruptcy law. *Id.* at 162.

[45] *Id*. at 162–63. It is important to recall that "allow" in the bankruptcy context means a "right to payment." 11 U.S.C. § 101(5)(A).

[46] *Vanston*, 329 U.S. at 165.

[47] *Id.* at 170 (Frankfurter, J., concurring).

[48] *Id.* (Frankfurter, J., concurring).

beginning with state law in a federal court of equity could undo the goals of uniformity found in the Bankruptcy Code, but he believed that the goal of bankruptcy was *geographic* uniformity, not outcome uniformity.[49]

Six months before Congress's comprehensive Bankruptcy Code replaced the Bankruptcy Act in 1979,[50] the Supreme Court decided *Butner v. United States* to resolve a conflict between state law and the application of equitable principles.[51] The Court stated that "[p]roperty interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[52] According to the Court, the application of state law "serves to reduce uncertainty, discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'"[53] The Court has subsequently reinforced this principle on other occasions.[54]

B. The Bankruptcy Code and Postpetition Interest

Oversecured creditors gained the right to postpetition interest with the passage of § 506(b) and the Bankruptcy Code in 1978,[55] which became

[49] *Id*. at 172 (1946) (Frankfurter, J., concurring). "To establish uniform laws of bankruptcy does not mean wiping out the differences among the forty-eight States in their laws governing commercial transactions. The Constitution did not intend that transactions that have different legal consequences because they took place in different States shall come out with the same result because they passed through a bankruptcy court." *Id.* at 172–73 (1946) (Frankfurter, J., concurring).

[50] 1 COLLIER, *supra* note 1, at ¶ 20.03.

[51] 440 U.S. 48, 50–51 (1979). The question was whether a security interest extends to rental profits. *Id.* at 52. Two circuits created a rule of equity determining who received the rental profits. *Id.* at 53–54 (Third and Seventh Circuits). Five circuits applied state law to determine who owned the rental profits. *Id*. at 51–52 (Second, Fourth, Sixth, Eighth, and Ninth Circuits).

[52] *Id*. at 55. The Court reasoned that Congress could have determined how rents received on properties should be handled under bankruptcy law but chose not to exercise its law-making powers to do so. *Id.* at 54.

[53] *Id.* at 55 (quoting Lewis v. Manufacturers Nat. Bank of Detroit, 364 U.S. 603, 609 (1961)).

[54] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (". . . whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."); Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 450 (2007) ("the settled principle that ". . . '[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.'") (quoting Raleigh v. Illinois Dept. of Revenue, 530 U.S. 15, 20 (2000)).

[55] 1 COLLIER, *supra* note 1, at ¶ 2.01(c).

the subject of intense litigation.[56] In *United States v. Ron Pair Enterprises*, the Supreme Court interpreted § 506(b) and held that the plain language of the statute provided for unqualified recovery of postpetition *interest*.[57] Specifically, the Court examined the provision which stated that "there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or [s]tate statute under which such claim arose."[58] According to the Court, the grammatical structure of § 506(b) indicated that "reasonableness" applied *only to* "fees, charges, and costs," which was a distinct type of recovery from interest.[59] The Court explained that there was no reason to deviate from the plain meaning of § 506(b).[60] First, the Court believed that Congress added § 506(b) to make bankruptcy law more consistent than the previous case law.[61] Second, there was no need to repudiate bankruptcy courts' rights to equitably modify postpetition default interest because the option to apply equities to that species of interest was only a "flexible guideline" and not grounded in the text of the Act or Code.[62] Thus, bankruptcy courts had no implied right to equitably adjust postpetition interest rates.[63]

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[56] 11 U.S.C. § 506(b). Interested parties frequently contest postpetition interest claims because the amount of the claim can become quite large and impact the rights of other creditors to the debtor's estate. *See, e.g.*, *In re* Bowles Sub Parcel A, LLC, 792 F.3d 897, 900 (8th Cir. 2015) ($1,516,739 in default interest); *In re* Fam. Pharmacy, Inc., 614 B.R. 58, 61 (B.A.P. 8th Cir. 2020) ($442,843.51 in postpetition default interest); *see also In re* DWS Invs., Inc., 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990) (other creditors unlikely to receive a distribution if bankruptcy court enforced default interest rate). Postpetition interest is also known as "pendency interest" because it accrues after the debtor has filed her bankruptcy petition, while she is in bankruptcy proceedings. 4 COLLIER, *supra* note 23, ¶ 506.04. Similar to other claims in bankruptcy, creditors submit claims of proof for postpetition interest. *See, e.g.*, *In re Bowles,* 792 F.3d at 900.

[57] 489 U.S. 235, 240–41 (1989). The language at issue was "[T]here shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." *Id.* at 241. The primary issue in *Ron Pair* was a circuit split regarding the allowability of postpetition claims on consensual and nonconsensual liens. *Id.* at 237–38. The grammatical structure of 11 U.S.C. 506(b) meant that reasonableness only became a factor for "fees, charges and costs" and that they were a distinct type of recovery from interest. *Id.* at 241–42. Only when the plain meaning of the statute contravenes its legislative intent can courts go outside the plain meaning. *Id.* at 242.

[58] *Id.* at 242–43.

[59] *Id.* at 248–49.

[60] *Id.* at 242–43.

[61] *Id.*

[62] *Id.* at 248.

[63] *Id.*

Courts could not seem to agree on the meaning of *Ron Pair*.[64] Bankruptcy courts enforced—or declined to enforce—postpetition default interest on diverse grounds.[65] Many courts after *Ron Pair* cited *Vanston* for the proposition that courts could take a flexible, equitable approach in determining whether to allow postpetition default interest.[66] These courts often examined whether the default interest rate was reasonable as applied to the facts of the case.[67] Without an equitable approach, these courts claimed, some ex-ante bargains could decrease the payout to general unsecured creditors, a key policy underlying bankruptcy law.[68] On the other hand, some courts focused on the ex-ante bargains made prior to bankruptcy in enforcing default interest provisions.[69] The Eleventh

[64] *In re* Laymon, 958 F.2d 72, 74 (5th Cir. 1992) ("There is nothing in the *Ron Pair* decision that leads us to believe that the Supreme Court intended to speak to the rate of interest under § 506(b).") (emphasis omitted); *In re* Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994) ("What emerges from the post-*Ron Pair* decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations*."); In re* DWS Invs., Inc., 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990); *In re* Hollstrom, 133 B.R. 535, 537 (Bankr. D. Colo. 1991) ("Clearly, Section 506(b) should be construed to include reference to interest at the contract rate. This conclusion, however, does not settle the issue as to default rates 'since . . . the Supreme Court has held that contractual and other legally-established rights may sometimes conflict with equitable principles of distribution under the bankruptcy laws.'") (citations omitted).

[65] *Compare In re* AE Hotel Venture, 321 B.R. 209, 215 (Bankr. N.D. Ill. 2005) (stating that default interest is a penalty) *and In re* Timberline Prop. Dev., Inc., 136 B.R. 382, 386–87 (Bankr. D.N.J. 1992) (stating that the default interest rate was created to coerce repayment) *and In re* White, 88 B.R. 498, 511 (Bankr. D. Mass. 1988) (invalidating a forty-eight percent default interest rate because it was a penalty) *with In re* Sundale, Ltd., 410 B.R. 101, 105 (Bankr. S.D. Fla. 2009) (default interest is not a penalty under Florida law) *and In re* Dixon, 228 B.R. 166, 174 (W.D. Va. 1998) (holding that there is a presumption in favor of enforcing the contract default interest rate).

[66] *In re DWS* 121 B.R. at 848; *In re Hollstrom*, 133 at 538; *In re Laymon,* 958 at 74–75; *In re* Route One W. Windsor Ltd. P'ship, 225 B.R. 76, 86 (Bankr. D.N.J. 1998).

[67] *In re Terry*, 27 F.3d at 244; *In re* Haldes, 503 B.R. 441, 445 (Bankr. N.D. Ill. 2013).

[68] *In re* Hollstrom, 133 B.R. at 540 ("Sight must never be lost of the fact that these Debtors are in bankruptcy; there are too many creditors chasing too few dollars.").

[69] *In re* Lapiana, 909 F.2d 221, 224 (7th Cir. 1990) (decrying the "flight of redistributive fancy or a grant of free-wheeling discretion" that was invoked to justify redistribution of assets that should have been subject to pre-bankruptcy agreements and law). *See, e.g.*, *In re* K & J Properties, Inc., 338 B.R. 450, 460 (Bankr. D. Colo. 2005) (". . . substituting the court's equitable powers for the marketplace, as it is constrained by legislative dictate, is not without risks to stability of the judiciary that may accompany failure to restrain judicial discretion."); *In re* JTS/Simms, LLC, No. 11-07-12153 SA, 2008 WL 80123, at *4 (Bankr. D.N.M. Jan. 4, 2008) ("The Court

Circuit even concluded that § 506(b) had superseded *Vanston*.[70] Absent a specific bankruptcy rule to the contrary, these courts focused on state law as the touchstone of each postpetition default interest decision.[71]

C. State Law and Default Interest

State law may disallow ex-ante contracts for default interest if such interest is usurious,[72] unconscionable,[73] or stems from an invalid liquidated damages provision.[74] State law treatment of default interest is somewhat clearer than default interest under bankruptcy law because state statutes govern interest rates.[75] State courts tend to evaluate default interest rates for usury first.[76] The court will look at all interest, fees, and other charges to determine whether an interest rate is usurious.[77] Proving usurious intent can be difficult because courts are reluctant to enforce the extreme penalties associated with usury.[78] Other courts have applied an unconscionability analysis to default interest claims.[79] The unconscionability claim looks at procedural and substantive unconscionability.[80] Procedural unconscionability involves an unfair creation of the contract, while substantive unconscionability refers to unfair terms in the contract.[81] With unconscionability, the court is

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does not have carte blanche in the name of 'equity' to refashion agreements."); *In re* Parker, No. 15-CV-25-F, 2015 WL 5553767, at *2 (E.D.N.C. Sept. 17, 2015).

[70] *In re* Sublett, 895 F.2d 1381, 1386 (11th Cir. 1990).

[71] *Id*. at 1385; *In re* Sundale, Ltd., 410 B.R. 101, 104 (Bankr. S.D. Fla. 2009).

[72] Freeman v. Hawthorn Bank, 516 S.W.3d 417, 422 (Mo. Ct. App. 2017).

[73] *E.g.*, De La Torre v. CashCall, Inc., 422 P.3d 1004, 1009 (2018).

[74] *E.g.*, MetLife Cap. Fin. Corp. v. Washington Ave. Assocs., 732 A.2d 493, 496 (1999).

[75] *E.g.*, MO. REV. STAT. § 408.035 (2021); KAN. STAT. ANN. § 16-205(a).

[76] *E.g.*, Sikorsky Fin. Credit Union, Inc. v. Butts, 108 A.3d 228, 232–33 (2015); Wagnon v. Slawson Expl. Co., 874 P.2d 659, 664 (Kan. 1994); Kraus v. Mendelsohn, 97 A.D.3d 641, 641 (2012).

[77] *E.g.*, Bibi v. Elfrink, 408 P.3d 809, 819 (Alaska 2017) (looking at all the facts in the situation to determine whether the interest and fees charged exceeds the usury rate). The elements of usury include: "(1) an unlawful intent, (2) money or its equivalent, (3) a loan or forbearance, (4) the sum loaned must be absolutely, not contingently, payable, and (5) there must be an exaction for the use of the loan or something in excess of what is allowed by law." Freeman v. Hawthorn Bank, 516 S.W.3d 417, 422 (Mo. Ct. App. 2017).

[78] GRANT S. NELSON ET AL., REAL ESTATE FINANCE LAW 529–30 (6th ed. 2015) [hereinafter *Real Estate Finance*]; *see, e.g.*, Leteff v. Roberts, 555 S.W.3d 133, 138 (Tex. App. 2018) (a usurious debt allows a borrower to avoid a usurious obligation).

[79] *E.g.*, The Cantamar, L.L.C. v. Champagne, 142 P.3d 140, 151–52 (Ut. Ct. App. 2006); De La Torre v. CashCall, Inc., 5 Cal.5th 966, 975 (2018).

[80] Ramirez-Leon v. GGNSC, LLC, 553 S.W.3d 318, 324 (Mo. Ct. App. 2018).

[81] State *ex rel.* Vincent v. Schneider, 194 S.W.3d 853, 858 (Mo. 2006).

concerned with "an inequality so strong, gross, and manifest that it must be impossible to state it to one with common sense without producing an exclamation at the inequality of it."[82] An unconscionability standard is generally favored by lenders because courts are less likely to find that a default interest provision rises to the level of unconscionability.[83]

In contrast to usury and unconscionability, some courts have taken the position that default interest is a type of liquidated damages.[84] Under this theory, default interest functions to protect lenders' expectations from a defaulting debtor.[85] If the creditor can demonstrate that the rate was reasonable, the rate will be enforced.[86] Thus, the standard a complaining debtor must meet for liquidated damages is considerably lower than unconscionability or usury because the debtor only needs to show how the interest rate is unreasonable.[87] A seminal case highlighting this approach is *MetLife Capital Financial Corporation v. Washington Ave. Associates L.P.*[88] In *Metlife*, the New Jersey Supreme Court discussed the rationale behind default interest and held that the best approach to evaluating default interest was a liquidated damages framework.[89] Default interest, the court argued, makes up for the costs of administering a loan, some of which are difficult to determine at the time the loan agreement is entered.[90] When two sophisticated parties bargain at arms-length, late fees and charges

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[82] State v. Brookside Nursing Ctr., 50 S.W.3d 273, 277 (Mo. 2001) (en banc).

[83] *See* Steven W. Bender & Michael T. Madison, *The Enforceability of Default Interest in Real Estate Mortgages*, 43 REAL PROP. TR. & EST. L.J. 199, 214 (2008) (unconscionability standard is more lax from lender's perspective).

[84] Chem. Bank v. Am. Nat. Bank & Tr. Co. of Chicago, 535 N.E.2d 940, 946 (1989); Roodenburg v. Pavestone Co., 171 Cal. App. 4th 185, 195, 89 Cal. Rptr. 3d 558, 566 (2009).

[85] Inland Bank & Tr. v. Knight, 927 N.E.2d 777, 782 (2010) (distinguishing default interest from late charges and applying a liquidated damages analysis to the default interest rate); Raisin Mem'l Tr. v. Casey, 945 A.2d 1211, 1215–16 (remanding the case to the trial court to determine whether the default interest rate was a penalty or a liquidated damage). *See also* Fleet Bank of Massachusetts, N.A. v. One-O-Six Realty, Inc., No. CA943392G, 1995 WL 809482 , at *1 (Mass. Super. Jan. 31, 1995).

[86] MetLife Cap. Fin. Corp. v. Washington Ave. Assocs., 732 A.2d 493, 502 (1999); Art Country Squire, LLC v. Inland Mortg. Corp., 745 N.E.2d 885, 893 (Ind. Ct. App. 2001) (agreeing with *MetLife*); *but see* Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC, 393 P.3d 449, 455 (2017) (distinguishing *MetLife*; holding that the default interest/late charge was a penalty); OneUnited Bank v. Charles St. Afr. Methodist Episcopal Church of Bos., 501 B.R. 1, 11 (D. Mass. 2013) (applying the liquidated damages versus penalty framework, but refusing to enforce default interest provision because the bank failed to explain how default interest restored the benefit of its bargain).

[87] City of Richmond Heights v. Waite, 280 S.W.3d 770, 776 (Mo. Ct. App. 2009) (listing the requirements for liquidated damages).

[88] *MetLife*, 732 A.2d at 504.

[89] *Id.* at 496.

[90] *Id.* at 503.

represent predictable, commercially reasonable damages that are common in the current loan market.[91] The court also cautioned that, where a default interest rate appeared to be punitive, it would probably not be reasonable, and thus would not be enforced.[92] The court upheld the default interest as a valid liquidated damage charge.[93]

The Bankruptcy Code grew from a crude patchwork of laws into a comprehensive framework that sought to give the "unfortunate debtor" a fresh start, but the focus on creditors' state law entitlements waned through the years despite clear case law.[94] Originally, courts recognized that state laws provided the rule of decision for how some assets were distributed in bankruptcy; however, *Sampsell*, *Heiser*, and *Vanston*'s progeny created federal common law that applied equities to postpetition default interest.[95] Even with the advent of the Bankruptcy Code and the *Butner* and *Ron Pair* decisions, bankruptcy courts were all too quick to return to the pre-Code era of equities despite a clear mandate that state law determines postpetition interest and any such right under state law is "unqualified."[96] The split between equity and state law caused some confusion, and two competing viewpoints of bankruptcy law emerged onto the bankruptcy stage.[97] Courts struggled to reconcile these perspectives when deciding whether to allow claims for postpetition default interest.[98] Similarly, state law approaches to default interest lack certainty.[99] Three recent cases point toward a unifying perspective of default interest that would increase certainty around ex-ante agreements, respect uniformity of bankruptcy law, and curtail the disfavored approach of federal common law.

III. RECENT DEVELOPMENTS

The first development arrived in 2014 and featured a recalcitrant debtor who tested the very limits of equitable principles vested in the bankruptcy court.[100] In 2020, the understanding of the law around § 506(b) began to change in two decisions: one in which the Supreme Court

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[91] *Id.* at 504

[92] *Id*. at 504–05.

[93] *Id*. at 505.

[94] Hanover Nat. Bank v. Moyses, 186 U.S. 181, 185 (1902).

[95] *See supra* notes 27–50.

[96] *See supra* notes 51–63.

[97] Grohsgal, *supra* note 20, at 717 (arguing that the Creditor's Bargain Theory is weak and bankruptcy law itself should be consulted instead).

[98] *Ron Pair Enters., Inc.*, 489 U.S. at 248.

[99] *Compare* Sikorsky Fin. Credit Union, Inc. v. Butts, 108 A.3d 228, 232 (2015) (usury analysis), *with* MetLife Cap. Fin. Corp. v. Wash. Ave. Assocs., 732 A.2d 493, 502 (1999) (liquidated damages analysis).

[100] *See generally* Law v. Siegel, 571 U.S. 415 (2014).

provided a general principle regarding federal common law,[101] and another in which the Eighth Circuit highlighted the conflict among the circuits regarding postpetition default interest.[102]

A. Equities Cannot Exceed the Code

When Jason Law filed for bankruptcy in 2004, his only significant asset was his home.[103] Law created a fictitious lien on the home to hide equity in his home from the bankruptcy trustee.[104] After five years of expensive litigation,[105] the bankruptcy court "surcharged" the state law-based homestead exemption to compensate the trustee for litigation expenses.[106] The Ninth Circuit Bankruptcy Appellate Panel ("BAP") and Ninth Circuit both affirmed the bankruptcy court's decision.[107] Justice Scalia, writing for a unanimous Supreme Court, held that the bankruptcy court could not surcharge the homestead exemption because doing so would contravene an express provision of the Bankruptcy Code requiring respect for exemption protections in the Code.[108] Despite the equitable nature of bankruptcy courts and the inequitable outcome this case produced, Congress exercised its constitutional authority to regulate bankruptcy and opted to allow certain state law exemptions.[109]

B. The Supreme Court Disfavors Judicial Rulemaking

Six years after the Supreme Court handed down its decision in *Siegel* confining bankruptcy courts' equitable powers, the Supreme Court

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[101] Rodriguez v. Fed. Deposit Ins. Corp., 140 S. Ct. 713, 718 (2020).

[102] *In re* Fam. Pharmacy, Inc., 614 B.R. 58, 65 (B.A.P. 8th Cir. 2020).

[103] *Law*, 571 U.S., at 418.

[104] *Id*. at 419. Two liens, combined with California's homestead exemption, created the impression that Law had no equity in the home. *Id*. at 418. A homestead exemption is a state law exclusion on property that does not enter the bankruptcy estate. *E.g.*, *In re* Bennett, 395 B.R. 781, 789 (Bankr. M.D. Fla. 2008). At the time the case was decided, California law allowed a $75,000 homestead exemption, meaning that the debtor could retain $75,000 from the sale of the home even if the debtor had outstanding obligations to other debtors. *Law*, 571 U.S. at 418.

[105] *Law*, 571 U.S. at 419. The Bankruptcy trustee incurred $500,000 of attorney fees to defeat Law's fictitious lien. *Id.* at 420.

[106] *Id*. Surcharging an exemption means that the court disallows the debtor from taking the exemption, usually requiring the debtor to hand over the surcharged property to the bankruptcy trustee. *In re* Koss, 319 B.R. 317, 323 (Bankr. D. Mass. 2005).

[107] *Law*, 571 U.S. at 420 (the Ninth Circuit stated that surcharging the exemption was important to "protect the integrity of the bankruptcy process").

[108] *Id.* at 427–28.

[109] *Id*. at 426–27.

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decided *Rodriguez v. FDIC*.[110] The Court took the *Rodriguez* case to warn against the creation of federal common law rules.[111] According to the Court, federal courts should create federal common law only when there is a "uniquely federal interest."[112] The *Rodriguez* Court cited *Butner* for the proposition that state law generally determines the property rights in bankruptcy.[113] It admonished federal courts for "moving too quickly past important threshold questions at the heart of our separation of powers."[114] Because there was no federal interest, federal courts should not "tak[e] up an invitation to try their hand at common lawmaking."[115]

C. A Potential Bright-Line Rule for Postpetition Default Interest

The Eighth Circuit BAP departed from the majority of circuit court approaches by enforcing a postpetition default interest provision against an insolvent debtor.[116] In *Family Pharmacy*, the BAP disagreed with the bankruptcy court that the default interest rate was a penalty under Missouri law,[117] and the court concluded that the penalty analysis did not apply to postpetition interest.[118] According to the BAP, the creditor was entitled to postpetition default interest because it was oversecured and the applicable loan documents comported with state law.[119] The Eighth Circuit argued that the bankruptcy court should not have weighed equitable considerations under the plain language of § 506(b).[120] While equitable considerations may be appropriate in certain situations, the Code does not authorize bankruptcy courts to apply equitable considerations to the controversy in *Family Pharmacy*.[121] Any expansion of equitable powers would be a creation of federal common law, an action disfavored by the

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[110] Rodriguez v. FDIC, 140 S. Ct. 713, 714 (2020). In the absence of a state law, federal courts created the "*Bob Richards* Rule" to determine how a refund from a consolidated group of businesses should be distributed. *Id*. at 716–17.

[111] *Id*. at 718.

[112] *Id*. at 717. The rule at issue governed corporations which are "creatures of state law," so there was no federal interest. *Id.* at 718 (*quoting* Cort v. Ash, 422 U.S. 66, 84, (1975)).

[113] *Id*. at 718.

[114] *Id.*

[115] *Id*.

[116] *In re* Fam. Pharmacy, Inc., 614 B.R. 58, 65 (B.A.P. 8th Cir. 2020).

[117] *Id*. at 61. Missouri law allows any rate of interest. MO. REV. STAT. § 408.035 (2021).

[118] *In re Fam. Pharmacy*, 614 B.R. at 61.

[119] *Id.* at 67.

[120] *Id*. at 61.

[121] *Id*. at 66. "[E]quitable considerations are to be used sparingly and only in exceptional circumstances." *Id* at 67.

Supreme Court.[122] Under this statute and the holding in *Ron Pair*, the creditor was entitled to all interest on its claim.[123]

The Supreme Court's emphasis in *Siegel* on following the Bankruptcy Code despite the equities of the case, combined with the Court's disapproval of judicial law-making, forms an backdrop for a nascent circuit split on postpetition default interest.[124]

IV. DISCUSSION

The central objective of this Note is to propose a uniform approach to postpetition default interest. The current lack of uniformity leads to greater transaction costs and less certainty in bankruptcy.[125] These costs are especially unfortunate in bankruptcy because the lack of financial resources is the primary reason the debtor is at the courthouse doors.[126] While the Code works to rehabilitate the "unfortunate debtor,"[127] bankruptcy law is an exercise in determining who can draw how much from the common pool of assets.[128] Thus, bankruptcy law should offer a coherent, uniform approach that helps courts more efficiently distribute assets. There is no current approach that neatly addresses postpetition default interest.[129] Recent rulings in *Rodriguez* and *Family Pharmacy* should alert bankruptcy judges that the majority position on postpetition default interest is not in harmony with the settled law of *Butner* and *Ron Pair*.[130]

The bankruptcy courts' reliance on equitable principles has strayed far from the holdings in *Butner* and *Ron Pair*.[131] In the absence of contrary instruction by Congress, bankruptcy courts must rely on state law to

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[122] *Id*. at 66.

[123] *Id.* at 61–62.

[124] *In re* Laymon, 958 F.2d 72, 75 (5th Cir. 1992) (contract rate presumed allowed unless the equities of the case dictate otherwise*); In re* Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994) (contract rate presumed allowed unless the equities of the case dictate otherwise); *In re Fam. Pharmacy,* 614 B.R at 62 (right to postpetition default interest is unqualified); Gen. Elec. Cap. Corp. v. Future Media Prods., Inc., 547 F.3d 956, 961 (9th Cir. 2008) (contractual rate of interest is presumed allowed unless non-bankruptcy law states otherwise); *In re* Sublett, 895 F.2d 1381, 1386 (11th Cir. 1990) (suggesting *Vanston* has been overruled and the key inquiry is solvency of the estate).

[125] Jackson, *supra* note 31, at 862.

[126] *In re* Hollstrom, 133 B.R. 535, 540 (Bankr. D. Colo. 1991).

[127] Hanover Nat. Bank v. Moyses, 186 U.S. 181, 192 (1902).

[128] Jackson, *supra* note 31, at 857; *see also* David Gray Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 453 (1992).

[129] *In re* Fam. Pharmacy, Inc., 614 B.R. 58, 66 (B.A.P. 8th Cir. 2020).

[130] *Id.*; *see also* Craig H. Averch, et al. *The Right of Oversecured Creditors to Default Rates of Interest from A Debtor in Bankruptcy*, 47 BUS. LAW. 961, 990 (1992).

[131] Averch, *supra* note 130, at 975.

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determine whether postpetition default interest is allowed.[132] Many courts since *Butner* have rejected the rule that state law defines rights in bankruptcy.[133] Due to the compensatory nature of default interest,[134] courts should apply a state-law liquidated damages analysis to postpetition default interest.[135] The state law-centric approach provides more certainty because there is more case law explaining liquidated damages,[136] and the Supreme Court has said that state law should govern.[137] Thus, the proposed analysis in this Note should be adopted by judges and attorneys alike in analyzing postpetition default interest because it would resolve the unorganized, federal common law approach bankruptcy courts have taken in the past.

A. Applying Siegel *and* Rodriguez *to Equitable Principles*

Bankruptcy courts have long chosen the path of equitable principles in resolving disputes over money in bankruptcy.[138] However, the opportunity cost of paying one creditor comes at the cost of paying another.[139] The Supreme Court recognized this issue in *Vanston*,[140] and lower courts were eager to invalidate postpetition default interest with their broad equitable powers to maximize the dividend to general unsecured creditors.[141] Due to some statutory ambiguity in § 506(b),[142] early cases were justified in construing this section of the Code to permit equitable adjustment of interest.[143] However, *Ron Pair* was quite forceful in holding that creditors have an "unqualified" right to interest under § 506(b).[144] Where a right is unqualified in the Code, it seems strange that courts dilute that unqualified right to a mere presumption that the debtor

[132] Butner v. United States, 440 U.S. 48, 55 (1979).

[133] *In re* Hollstrom, 133 B.R. 535, 540 (Bankr. D. Colo. 1991); *In re* DWS Invs., Inc., 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990); *In re* W.S. Sheppley & Co., 62 B.R. 271, 278 (Bankr. N.D. Iowa 1986).

[134] Bender, *supra* note 84, at 201–02.

[135] *Infra* notes 218–20.

[136] *E.g.*, MetLife Cap. Fin. Corp. v. Washington Ave. Assocs. L.P., 732 A.2d 493, 505 (1999) (discussing default interest).

[137] *Butner*, 440 U.S. at 55.

[138] *Supra* notes 65–69.

[139] *In re* Hollstrom, 133 B.R. 535, 541 (Bankr. D. Colo. 1991).

[140] Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 165 (1946).

[141] *In re* DWS Invs., Inc., 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990) (adopting a flexible approach).

[142] United States v. Ron Pair Enter., 489 U.S. 235, 249 (1989) (O'Connor, J., dissenting).

[143] *In re* W.S. Sheppley & Co., 62 B.R. 271, 278 (Bankr. N.D. Iowa 1986).

[144] *Ron Pair*, 489 U.S. at 241.

or trustee could rebut with equitable pleas.[145] The courts' various approaches also undermined the goal of uniformity in bankruptcy proceedings because different circuits applied § 506(b) in different ways.[146]

Rodriguez warns courts against creating common law.[147] As bankruptcy courts adopted "flexible approaches,"[148] reclassified interest as fees,[149] and cited pre-Code law as controlling,[150] all in the name of equity, they stitched together a common-law Frankenstein that continues to baffle courts.[151] Congress has expressly addressed interest through § 506(b) and chosen to give creditors an unqualified right to postpetition interest.[152] While it is true that the *Ron Pair* Court did not set a rate of interest for bankruptcy courts to apply,[153] *Butner* supplies the rule of decision—that state law governs the underlying obligation.[154] The Supreme Court decided *Butner* after Congress passed the Bankruptcy Code, but before it took effect.[155] As the *Butner* Court theorized, Congress had every opportunity to legislate default interest but declined to do so.[156] Because Congress did not modify a creditor's right to postpetition default interest, it would seem that default interest is not a "unique federal interest."[157] Without the unique federal interest required under *Rodriguez*, bankruptcy courts are foreclosed from "trying their hand at common law-making."[158] Bankruptcy courts may not contravene express provisions of the bankruptcy code.[159]

Siegel is particularly notable because of the outrageous conduct of the debtor.[160] If a bankruptcy court may not disregard a Code-sanctioned state law provision to penalize a bad-faith debtor, then bankruptcy courts

[145] *In re* Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994) ("What emerges from the post-*Ron Pair* decisions is a presumption in favor of the contract rate subject to rebuttal based upon equitable considerations.").

[146] Hanover Nat. Bank v. Moyses, 186 U.S. 181, 187–88 (1902); Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 172 (1946) (Frankfurter, J., concurring).

[147] Rodriguez v. Fed. Deposit Ins. Corp., 140 S. Ct. 713, 718 (2020).

[148] *In re* DWS Invs., Inc., 121 B.R. 845, 849 (Bankr. C.D. Cal. 1990).

[149] *In re* Consol. Properties Ltd., 152 B.R. 452, 455 (Bankr. D. Md. 1993).

[150] *In re* Laymon, 958 F.2d 72, 75 (5th Cir. 1992).

[151] *See In re* Fam. Pharmacy, Inc., 614 B.R. 58, 65–66 (B.A.P. 8th Cir. 2020).

[152] 11 U.S.C. § 506(b).

[153] Averch, *supra* note 130, at 971.

[154] Butner v. United States, 440 U.S. 48, 55 (1979).

[155] 1 COLLIER, *supra* note 1, ¶ 20.03.

[156] *Butner*, 440 U.S. at 54.

[157] Rodriguez v. Fed. Deposit Ins. Corp., 140 S. Ct. 713, 717 (2020).

[158] *Id*. at 718.

[159] Law v. Siegel, 571 U.S. 415, 427–28 (2014).

[160] *Id*. at 419–20.

certainly may not deny creditors default interest under § 506(b), no matter how deserving the situation is of equities.[161] Judge Posner succinctly stated that "[c]reditors have rights . . . [and] bankruptcy judges are not allowed to dissolve those rights in the name of equity."[162] From the perspective of the *Siegel* and *Rodriguez* decisions, the court in *Family Pharmacy* was correct to hold that bankruptcy courts should not apply equitable principles to postpetition default interest.[163] However, *Family Pharmacy* was not quite correct about the interplay between postpetition default interest and state law theories—namely, liquidated damages.[164]

B. The Correct Understanding of Default Interest

Although courts should shun equitable solutions to default interest, they should not disregard state-law prohibitions on default interest. State usury law may disappoint parties hoping to avoid excessive default interest charges because of the courts' hesitancy to enforce such a severe penalty.[165] Unconscionability claims are always available as a defense to ex-ante contract formation, but such a showing of oppression has a strict factual standard.[166] A liquidated damages analysis is the most likely state law theory to invalidate an ex-ante default interest agreement.[167] Statutory definitions summon a superficially straightforward application of state interest laws, but crafty creditors trying to work around state laws with various "financing charges" have produced a more nuanced reading of the law.[168] The concept of changing form but not substance to gain preferential treatment is not new to the law.[169] Thus, any threshold inquiry regarding the enforcement of postpetition default interest should examine the function of default interest as well as any other charges associated with the agreement to determine how that agreement should be enforced against the debtor,[170] and, by extension, other creditors.[171] Understanding the function of default interest in greater detail demonstrates why the Eighth Circuit's analysis of default interest in *Family Pharmacy* is incorrect.

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[161] *Id*. at 427–28.

[162] *In re* Lapiana, 909 F.2d 221, 224 (7th Cir. 1990).

[163] *In re* Fam. Pharmacy, Inc., 614 B.R. 58, 61 (B.A.P. 8th Cir. 2020).

[164] MetLife Cap. Fin. Corp. v. Washington Ave. Assocs., 732 A.2d 493, 502 (1999).

[165] *Real Estate Finance*, *supra* note 79.

[166] *Supra* notes 80–84.

[167] *E.g.*, *MetLife*, 732 A.2d at 502.

[168] Bibi v. Elfrink, 408 P.3d 809, 819 (Alaska 2017) (discussing "disguised interest").

[169] Grohsgal, *supra* note 20, at 755 (describing how some tax planners attempt to characterize equity as debt to obtain favorable tax treatment).

[170] *E.g.*, *MetLife*, 732 A.2d at 499.

[171] *See In re* Hollstrom, 133 B.R. 535, 540 (Bankr. D. Colo. 1991).

The court in *Family Pharmacy* argued that default interest is not a liquidated damage, and the difference between default interest and liquidated damages is "readily discernable."[172] The court lifted language from an earlier opinion about liquidated damages:

> Although default interest and liquidated damages are similar in concept, the differences between the two are readily discernible, especially when applied to the facts in this case. When the term "default interest" is used, "default" refers to an event in a debtor-creditor relationship that triggers certain consequences typically set out in a loan document. One such consequence may be the escalation of the interest rate on remaining indebtedness, hence the term "default interest." In contrast, "liquidated damage" usually refers to a specific sum of money expressly stipulated as the amount of damages to be recovered for breach by either party to an agreement.[173]

According to the Eighth Circuit, the relationship of the parties and the nature of the liquidated damage award or default interest rate dictates the type of analysis courts employ.[174] While perhaps appropriate in state court analyses, this argument exalts form over substance, controverting bankruptcy policy,[175] because the instrument signed by the parties calls them "creditor" and "debtor." In a setting other than default interest, an "event" also "triggers certain consequences typically set out" in an applicable document.[176] For a real estate purchase contract that includes an earnest money provision, the event "trigger[ing] certain consequences typically set out" in an applicable document is a failure to perform.[177] Liquidated damages are a consequence that compensate for a failure to pay the principal at the maturity date, or a failure to perform according to the contract.[178]

The Restatement (Second) of Contracts indicates that the primary goal of liquidated damages is compensation.[179] In the most basic sense, the default interest rate compensates lenders for the damages they suffer when the borrower does not return the lender's funds.[180] These damages

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[172] *In re* Fam. Pharmacy, Inc., 614 B.R. 58, 63 (B.A.P. 8th Cir. 2020).

[173] *Id.* (quoting Direct Transit, Inc. v. S. Dakota Governor's Office of Econ. Dev. (In re Direct Transit, Inc.), 226 B.R. 198, 201 (8th Cir. BAP 1998)).

[174] *Id.*

[175] Pepper v. Litton, 308 U.S. 295, 303 (1939).

[176] *See* Proulx v. 1400 Pennsylvania Ave., SE, LLC, 199 A.3d 667, 670 (D.C. 2019).

[177] *Id*.

[178] Bender, *supra* note 84, at 201–02.

[179] RESTATEMENT (SECOND) OF CONTRACTS § 356 (AM. L. INST. 1981).

[180] *In re* John Q. Hammons Fall 2006, LLC, 612 B.R. 779, 802 (Bankr. D. Kan.), as amended (Jan. 21, 2020), on reconsideration, 614 B.R. 371 (Bankr. D. Kan. 2020) (restating the testimony of an expert witness who testified of the myriad ways default

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include the loss of regular interest, the opportunity costs of foregoing other investments, and the additional internal costs the lender must incur to secure repayment.[181] An amicus brief in a state court explained that lenders who do not receive the interest and principal at the maturity date lose working capital that they normally use to loan money to other borrowers.[182] Default interest rates empower lenders to offer competitive rates in a competitive marketplace because their losses from tardy payments are recouped to some degree.[183] Default interest rates strengthen the value of promissory notes sold to collection agencies, furthering the availability of lenders to loan capital to those seeking financing.[184] Default interest rates insure lenders' reserves against the risk of nonpayment.[185] The monetary risk on nonpayment can be difficult to ascertain ahead of time.[186] A default interest rate efficiently estimates the lender's damages.[187] Because foreclosure and sale of assets are risky routes to repayment and lenders often lose money through the foreclosure process, default interest rates provide greater security.[188] Due to these foreclosure difficulties, parties enter into contracts that provide increased interest on default.[189]

Earnest money deposits in real estate transactions are analogous to default interest provisions.[190] If the buyer completes the purchase, she

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interest protects the lender); *see also* Sikorsky Fin. Credit Union, Inc. v. Butts, 315 Conn. 433, 442, 108 A.3d 228, 234 (2015).

[181] Bender, *supra* note 84, at 201–02. These losses also include "the need for regulated lenders to place additional money on reserve based on defaulted loans in their portfolio (which diverts money from income-producing investments); the possibility that the negative impact of a nonperforming loan on the lender's balance sheet could cause regulatory problems and make obtaining funding in the credit markets more expensive; . . ." *Id*. at 202.

[182] Dobson Bay Club II DD, v. La Sonrisa de Siena, LLC, 242 Ariz. 108, 118, (2017) (Bolick, J., dissenting).

[183] Citibank, N.A. v. Nyland (CF8) Ltd., 878 F.2d 620, 625 (2d Cir. 1989) (questioning whether an inability to charge default rates might create larger interest rates over the life of other borrower's loan in order to spread the risk of loss over the full life of the loan).

[184] *Dobson Bay Club*, 242 Ariz. at 118 (Bolick, J., dissenting) (default interest and other contractual fees make otherwise unappealing notes more valuable to collection agencies, whose purchasing of notes allows lenders to maintain necessary liquidity).

[185] Bender, *supra* note 84, at 210–11.

[186] MetLife Cap. Fin. Corp. v. Washington Ave. Assocs. L.P. 732 A.2d 493, 503 (1999).

[187] Proulx v. 1400 Pennsylvania Ave., SE, LLC, 199 A.3d 667, 673 (D.C. 2019).

[188] *Cf.* Bender, *supra* note 84, at 202.

[189] *E.g.*, *MetLife*, 732 A.2d at 503.

[190] *Cf. Proulx*, 199 A.3d at 670 (stating that an agreed upon sum helps parties resolve a dispute outside litigation).

maintains her legal right to the deposit,[191] similar to how if the debtor pays on time, she maintains her legal right to pay interest at the nondefault rate.[192] Similar to default interest and loans, the costs of carrying, marketing, and selling real estate can be hard to define before the damages to the seller occur.[193] Thus, state courts analyze provisions for earnest money as a liquidated damage because of the legal function of the earnest money provision.[194] When a frustrated seller does not sell her home as anticipated by contract, she is entitled to damages that would place her in the position she would have occupied but for the breach.[195] While the subject matter is different, the legal obligations and consequences for an earnest money provision and default provision are the same.[196] In both settings, two parties exchanged promises, gave consideration, and became legally bound.[197] A contract with a valid liquidated damages clause and an agreement to loan money with a default interest are conceptually the same instruments, and courts should treat them the same and dutifully enforce the postpetition default interest provision.[198]

Unfortunately, late fees and other charges often obscure what should be a straight-forward analysis of default interest.[199] Some courts have allowed creditors and debtors to agree to these charges as penalties for failing to perform, and the courts view these fees as liquidated damages because they account for servicing the loan.[200] As a result, some courts get tangled up in contract and case law and mischaracterize default interest as a charge.[201] Later courts have been all too eager to recycle previous courts' reasoning to disallow default interest, even if that reasoning is not sound.[202] One of the most-cited decisions, *AE Hotel Venture*, excitably

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[191] *See* WFC Lynnwood I LLC v. Lee of Raleigh, Inc., 817 S.E.2d 437, 441 (2018).

[192] *See MetLife*, 732 A.2d at 496.

[193] Browne & Price, P. A. v. Innovative Equity Corp., 864 S.E.2d 686, 691 (2021).

[194] *Id*.

[195] *Id*.

[196] *Compare MetLife*, 732 A.2d at 503 (analyzing and enforcing default interest as a liquidated damage for which parties had bargained for) *with* Proulx v. 1400 Pennsylvania Ave., SE, LLC, 199 A.3d 667, 676 (D.C. 2019) (analyzing and enforcing a deposit as a liquidated damage for which parties had bargained for).

[197] *See* Luebbert v. Simmons, 98 S.W.3d 72, 77 (Mo. Ct. App. 2003).

[198] *See id.*

[199] *Real Estate Finance*, *supra* note 79, at 529–30.

[200] *Id.* at 530.

[201] *In re* Consol. Prop. Ltd. P'ship, 152 B.R. 452, 455 (Bankr. D. Md. 1993).

[202] *In re* AE Hotel Venture 321 B.R. 209, 215–16 (Bankr. N.D. Ill. 2005); *In re* Haldes, 503 B.R. 441, 445 (Bankr. N.D. Ill. 2013); *In re* Wolverine, Proctor & Schwartz, LLC, 449 B.R. 1, 5 (Bankr. D. Mass. 2011); *In re* Mkt. Ctr. E. Retail Prop., Inc., 433 B.R. 335, 365 (Bankr. D.N.M. 2010) (citing *AE Hotel* for the proposition that creditors cannot collect late fees and default interest); *In re* Brandywine

warned that allowance of late fees *and* default interest raise the "spectre of double recovery."[203] This mischaracterization sadly disregards the literature and case law that correctly characterizes default interest as a species of liquidated damages.[204] Indeed, *AE Hotel* relied on *Consolidated Properties* for the proposition that default interest is a fee or charge,[205] but *Consolidated Properties* cited no authority for such premise.[206] Instead, *Consolidated Properties* cited a case in the Fourth Circuit to suggest that interest and charges are two different recoveries and mistakenly proceeded to indiscriminately lump default interest in with charges.[207] This characterization also misses the point that late fees and default interest account for two distinct types of losses.[208]

Because bankruptcy courts may not engage in a "flight of redistributive fancy," any attempt to modify postpetition default interest must come from state law.[209] State law frameworks for liquidated damages analyses accommodate the correct theoretical framework for bankruptcy courts' assessments of postpetition default claims.[210] The liquidated damages framework places postpetition default interest in its proper context, as an amount that compensates creditors for delayed repayment and foregone opportunities without bogging down courts in extensive evaluations of the loan's worth.[211] After examining the history of bankruptcy law, the intersection of state and local powers, and the rationale of default interest, a simple solution presents itself to judges and litigants faced with the infamous postpetition default interest clause.

Townhouses, Inc., 518 B.R. 671, 680 (Bankr. N.D. Ga. 2014) (disallowing late charges and allowing default interest as an unsecured claim but approving the holding of *AE Hotel*); *In re* Cottonwood Corners Phase V, LLC, 2012 WL 566426, at *11 n.8 (Bankr. D.N.M. Feb. 17, 2012) (allowing postpetition default interest on the grounds that it is not an unreasonable charge); *In re* Kalian, 178 B.R. 308, 317 (Bankr. D.R.I. 1995) (holding on alternative grounds that the default interest rate is an unreasonable charge but citing *AE Hotel* for the proposition that default interest is a charge).

[203] *In re AE Hotel* 321 B.R. at 216.

[204] *Supra* notes 168–76.

[205] *In re AE Hotel* 321 B.R. at 215.

[206] *In re Consol. Prop.,* 152 B.R. at 455.

[207] *Id*. at 455. The court also states that the right to postpetition interest under *Ron Pair* is not absolute, even though the Supreme Court stated in *Ron Pair* that the right to postpetition interest is unqualified. *Id*. Of course, interest rates may not violate state laws, but absent state law violations, the creditor's right to postpetition interest is unqualified. United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241 (1989).

[208] *Real Estate Finance*, *supra* note 79, at 538.

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

[210] *See supra* notes 183–202.

[211] *See* Proulx v. 1400 Pennsylvania Ave., SE, LLC, 199 A.3d 667, 673 (D.C. 2019).

C. Charting a Path Forward

The resulting path forward must be one that secures uniform bankruptcy law and avoids federal common law.[212] *Family Pharmacy* highlights the divergence of bankruptcy courts from *Ron Pair* but misunderstands the role liquidated damages play in resolving default interest claims.[213] Courts should not excuse debtors from improvident bargains, for such would grant debtors a windfall.[214] However, bankruptcy proceedings are not solely about the debtor—they are distributive exercises among other creditors, too.[215] If the resulting payout from the debtors' estate would not fully compensate all creditors, those creditors who stood to collect less than full recovery should be able to contend that the relevant default interest rate is not a reasonable estimation of the other creditor's damages under state law. At that point, the complaining creditor(s) have the burden of demonstrating how the allegedly unreasonable default interest rate fails to function as a liquidated damage.[216] If the complaining creditor makes such a showing under state law, the bankruptcy court may exercise its equitable powers to modify the interest rate, inasmuch as state law has dictated the default interest rate is not a liquidated damage. Usury, penalty, and unconscionability attacks would be available to the extent state law grants those rights.[217] This standardized approach according state law the central place of analysis would fulfill Justices Fuller and Frankfurter's vision of a uniform bankruptcy law while honoring rights acquired under state law.[218]

States have long recognized the liquidated damages versus penalty framework.[219] This framework mirrors the equitable principles important to the bankruptcy court but grounds the analysis in state common law, rather than the disfavored federal common law.[220] Commercial lenders need not worry that a liquidated damages framework would make their

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[212] *In re* Fam. Pharmacy, Inc., 614 B.R. 58, 66 (B.A.P. 8th Cir. 2020).

[213] *Id*. at 61.

[214] *In re* Consol. Operating Partners, 91 B.R. 113, 117 (Bankr. D. Colo. 1988).

[215] Jackson, *supra* note 31, at 857.

[216] MetLife Cap. Fin. Corp. v. Washington Ave. Assocs. L.P., 732 A.2d 493, 502 (1999) (default interest rate is freely negotiable, thus presumptively valid).

[217] Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 170 (1946) (Frankfurter, J., concurring).

[218] *Id.* at 172–73 (Frankfurter, J., concurring); Butner v. United States, 440 U.S. 48, 55 (1979).

[219] *E.g.*, City of Richmond Heights v. Waite, 280 S.W.3d 770, 775–76 (Mo. Ct. App. 2009).

[220] Rodriguez v. Fed. Deposit Ins. Corp., 140 S. Ct. 713, 718 (2020).

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interest rates more vulnerable to attack;[221] they are the drafting party and should be able to articulate why they bargained for the default interest.[222]

V. CONCLUSION

Courts may not give a remedy in equity to a right that does not exist in either state or federal law.[223] Since 1946, bankruptcy courts have struggled with the right of postpetition default interest.[224] Even after the Supreme Court clarified that the Bankruptcy Code authorizes postpetition default interest, courts have struggled to abandon their federal common law tendencies of applying equitable principles to suspect default interest provisions.[225] The Supreme Court vividly illustrated in *Siegel* that no action allows the court to contravene the Code,[226] and the Code gives an unqualified right to postpetition default interest to creditors.[227] The Code works to rehabilitate the debtor, but the debtor cannot hide from her contracts behind federal common law.[228] The state law liquidated damage analysis offers the most honest and straightforward approach to upholding the uniformity of bankruptcy law and stepping out of the shadow of federal common law surrounding postpetition default interest.

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[221] *MetLife*, 732 A.2d at 504 (reasonableness provides adequate "safeguards" for the lender).

[222] Swindell v. Fed. Nat. Mortg. Ass'n, 409 S.E.2d 892, 896 (1991) (onus is on the lender to know the law since she is loaning money for profit).

[223] Alfred Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1029 (1953).

[224] *See supra* note 65.

[225] *See supra* notes 66–67.

[226] Law v. Siegel, 571 U.S. 415, 427–28 (2014).

[227] United States v. Ron Pair Enters., Inc., 489 U.S. 235, 241 (1989).

[228] Hanover Nat. Bank v. Moyses, 186 U.S. 181, 185 (1902); Butner v. United States, 440 U.S. 48, 55 (1979).