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A Growing Consensus Emerges on the Calculation of Postpetition Interest

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Key Takeaways:

- Unsecured claimholders of a solvent debtor are entitled to postpetition interest on their claims, although the solvent debtor exception has been questioned in other jurisprudence.
- Courts have taken divergent views as to whether to apply the federal judgment rate or the prepetition contract rate (which is often substantially higher) to the calculation of postpetition interest on unsecured claims. Courts justify use of the federal judgment rate on uniformity principles, without considering its consequence of forcing creditors to subsidize the debtor's shareholders.
- The recent decision in PG&E's chapter 11 case is consistent with the growing trend among bankruptcy courts to apply the federal judgment rate, as it promotes uniformity within federal law, among other reasons.

The Issue

The recent decision by Judge Montali in PG&E's chapter 11 case provides the latest installment in the long-standing debate regarding the appropriate calculation of postpetition interest on general unsecured claims in solvent debtor cases.[1] The discrete legal issue before the court was whether the debtors' proposed plan of reorganization for solvent debtors leaves unimpaired four classes of unsecured claims by providing them par plus postpetition interest calculated at the federal judgment rate of 2.59% pursuant to 28 U.S.C. § 1961(a). Several parties, including the statutory creditors' committee and ad hoc groups for unsecured noteholders and trade claimants, urged that postpetition interest be calculated at the applicable contract rate of interest. Because the prepetition contract rate of interest often substantially exceeds the federal judgment rate (as is the case in PG&E), the decision to apply one rate of postpetition interest over the other may dramatically alter recoveries to holders of general unsecured claims.

Divergent Approaches Across Circuits

Bankruptcy courts have long taken divergent approaches to the appropriate calculation of postpetition interest on general unsecured claims in solvent debtor cases. At the center of the debate is a fundamental disagreement over the statutory interpretation of section 726(a)(5) of the Bankruptcy Code, which provides that an unsecured claimholder of a solvent debtor is entitled to "payment of interest *at the legal rate* from the date of the filing of the petition." 11 U.S.C. § 726(a)(5) (emphasis added).

Although the requirements of chapter 7 typically do not apply to chapter 11 cases, section 726 of the Bankruptcy Code applies indirectly through the "best interest of creditors" test in section 1129(a)(7), which requires that distributions proposed under a chapter 11 plan must at least equal the amount such holder would have received under a chapter 7 liquidation. Applying section 726(a)(5), a solvent debtor liquidating under chapter 7 would have to pay holders of general unsecured claims postpetition "interest at the legal rate" before it can make any distributions to equity interest holders.

In the seminal case of *In re Cardelucci,* the Ninth Circuit concluded that the reference by Congress to "the legal rate" in section 726(a)(5) was an intentional decision by Congress to favor a single, easily determined rate for all postpetition interest, particularly since Congress had rejected proposed language of "interest on claims allowed."[2] The growing trend in the law appears to favor this approach, with several recent decisions applying the federal judgment rate as the appropriate metric for postpetition interest.[3] These courts have argued, consistent with *Cardelucci*, that the application of a single, uniform interest rate, as opposed to varying rates based upon the individual contracts of each unsecured claimholder, ensures that no single creditor will receive a disproportionate share of any remaining assets to the detriment of other creditors. In addition to promoting the equitable treatment of creditors, these courts have ruled that the federal judgment rate also achieves judicial efficiency by eliminating the burdensome scenario under which a chapter 11 debtor would have to calculate postpetition interest at a different rate, based upon a different contract, for each individual creditor. Of course, the notion of equality among creditors who bargained for different deals may not be fair. And the calculation of interest at different rates is hardly a daunting task.

Taking the opposite view, the U.S. District Court for the Northern District of Illinois opined in *Dvorkin* that it would be "fundamentally unfair to require a creditor to accept a lower interest rate than he bargained for" in solvent cases.[4] While describing *Cardelucci* as "well-reasoned," it noted that the pre-Bankruptcy Code practice was to award postpetition interest at the contract rate where the debtor is solvent, and because Congress did not make its intent clear in section 726(a)(5) to replace the pre-Code rule, the bankruptcy court should "enforce creditors' rights according to the tenor of the contracts that created those rights."[5]

Recognizing the split in the law and analyzing the approaches taken in both *Cardelucci* and *Dvorkin*, the Bankruptcy Court in *In re Robinson*, found that the Ninth Circuit had "the better reasoned case and that the federal judgment rate is the correct rate to apply based on the phrase 'interest at the legal rate.'… Because Congress inserted a 'the' before 'legal rate,' it is apparent that it intended for courts to utilize the legal rate found in the federal statue, regardless of how Congress may decide to change the applicable rate under that statute in the future."[6] It rejected *Dvorkin*'s reliance on pre-Code case law's equitable approach and observed that the use of the federal judgment rate is "consistent with the general rule that post-petition interest is procedural in nature and dictated by federal law, and is equitable to all creditors."[7]

In a move that could have swung the pendulum to the other side, the Fifth Circuit in *Ultra Petroleum* opined in January 2019 that Congress' failure to specifically reference the federal judgment rate in 28 U.S.C. § 1962 was "meaningful" and indicated that bankruptcy courts may find that equity dictates that the higher contract or contract plus default rate may apply, although in the same opinion it questioned whether the solvent estate exception survived.[8] Such support for the contract rate of interest, however, was short lived, because the Fifth Circuit would go on to withdraw and substitute its opinion in November 2019.[9] In its revised opinion, the Fifth Circuit dropped its questioning of whether the solvent estate exception survived but declined to opine on the appropriate interest rate and instead remanded the issue to the bankruptcy court to consider what the "legal rate" of interest means under section 726(a)(5).

The PG&E Court Follows Cardelucci in Applying the Federal Judgment Rate

Under the principle of *stare decisis*, Judge Montali held that *Cardelucci* was binding because it was prevailing Ninth Circuit law and could not be distinguished. Even had it not been binding, the court stated it would have followed the opinion because it found its reasoning persuasive and had not been superseded in the two decades after the opinion had been rendered. In so doing, the court noted that "[t]he rule in the seventeen years since *Cardelucci* is clear: unsecured creditors of a solvent debtor will be paid the Federal Interest Rate whether their prepetition contracts call for higher or lower rates, or applicable state law judgment rates are higher, or there are no other applicable rates to consider." *Id*. at *8-9.

Does Application of the Federal Judgment Rate "Impair" Unsecured Claimholders?

While the federal judgment rate may provide unsecured claimholders with a lower rate than they contracted for, does its application constitute an impairment of their claims? In its analysis, the PG&E court agreed with the Fifth Circuit's more recent opinion in *Ultra II* that a creditor is not impaired in a reorganization plan where the plan incorporates the Code's disallowance provisions.[10] In other words, even though the unsecured claimholders may be entitled to the prepetition contract rate of interest under state law, they are unimpaired where it is the Bankruptcy Code itself, and not the plan, that alters the creditors' claim or rights. An important consequence of this analysis is that unsecured claimholders that receive par plus postpetition interest at the lower federal judgment rate lose the ability to vote to reject the plan because they are deemed to have accepted it pursuant to Bankruptcy Code section 1126(f).

Lessons for Distressed Debt Investors

The PG&E decision is the latest in a string of recent decisions that strongly support a rule that postpetition interest on unimpaired claims of a solvent debtor will be calculated at the federal judgment rate. Distressed debt investors should anticipate that courts are likely to align themselves with this growing trend. A careful eye should be kept on the decision of the bankruptcy court in *Ultra Petroleum* on remand. Whether the equities of the case should be used by the bankruptcy court to apply the contract rate of interest as opposed to the federal judgment rate will be hotly contested and likely appealed.

[1]*See* Memorandum Decision Regarding Postpetition Interest, *In re PG&E Corp.* Dkt. No. 5226; No. 19-30088 (Bankr. N.D. Cal. Dec. 30, 2019) ("PG&E Decision").

[2] *Onink v. Cardelucci (In re Cardelucci)*, 285 F.3d 1231 (9th Cir. 2002).

[3]*See*, *e.g.*, *In re Energy Future Holdings Corp.*, 540 B.R. 109 (Bankr. D. Del. 2015) (finding Congress's reference to "*the* legal rate interest" shows its intention to use the federal judgment rate) (emphasis in original). *In re Washington Mut., Inc.*, 461 B.R. 200, 211 (Bankr. D. Del. 2011), vacated in part, No. 08-12229 MFW, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012) (finding that the federal judgment rate was required by section 726(a)(5) but indicating that the court may have discretion to alter it); *In re Garriock*, 373 B.R. 814 (E.D. Va. 2007); *In re Adelphia Communications Corp.*, 368 B.R. 140 (Bankr. S.D.N.Y. 2007); *In re Dow Corning Corp.*, 237 B.R. 380 (Bankr. E.D. Mich. 1999)

[4] *Dvorkin Holdings, LLC*, 547 B.R. 880, 898 (N.D. Ill. 2016).

[5] *Id.* at 893.

[6] 567 B.R. 644, 648 (Bankr. N.D. Ga. 2017).

[7] *Id.* at 8 (citations omitted).

[8] *Ultra Petroleum Corp. v. Ad Hoc Comm. of Unsecured Creditors of Ultra Res., Inc. (In re Ultra Petroleum Corp.)*, 913 F.3d 533, 546 (5th Cir. 2019) ("Ultra I")

[9] *Ultra Petroleum Corp. v. Ad Hoc Comm. of Unsecured Creditors of Ultra Res., Inc. (In re Ultra Petroleum Corp.)*, __ F. 3d. __, 2019 WL 6318074 (5th Cir. Nov. 26, 2019) ("Ultra II").

[10] *Id.*

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