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9th Circ. Ruling Highlights Divide On Ch. 11 Interest Rates

By **Seth Kleinman and Miranda Russell** (September 16, 2022, 5:05 PM EDT)

Seth Kleinman

Miranda Russell

On Aug. 29, in the Pacific Gas and Electric Corp. bankruptcy matter, the U.S. Court of Appeals for the Ninth Circuit[1] became the first circuit-level court to address the question of what is the correct rate of interest to be applied to unimpaired unsecured claims against a fully solvent debtor.[2]

In its decision, the Ninth Circuit reversed the U.S. Bankruptcy Court for the Northern District of California and U.S. District Court for the Northern District of California rulings and held that such creditors are entitled to receive post-petition interest at the contractual rate or the state law default rate, which are almost always significantly higher than the federal judgment rate.

Outside of the Ninth Circuit, in a series of recent decisions, bankruptcy courts have been somewhat divided on the issue.

In the U.S. District Court for the District of Delaware last year, for example, U.S. Bankruptcy Judge Mary F. Walrath found in In re: Hertz Corp. that unimpaired creditors need only receive interest at the federal judgment rate in solvent debtor cases.[3]

Notably, the Hertz court stated that it was not persuaded by the argument that the U.S. Bankruptcy Code incorporated the solvent debtor exception to the extent suggested by other bankruptcy courts.[4]

Similarly, in an unpublished decision in In re: Latam Airlines Group SA in 2020, U.S. Bankruptcy Judge James L. Garrity Jr. from the U.S. Bankruptcy Court for the Southern District of New York agreed with the Hertz court and found that unimpaired unsecured creditors should be paid post-petition interest at the federal judgment rate.[5]

On the other end of the spectrum, in In re: Ultra Petroleum Corp. in 2020, the U.S. Bankruptcy Court for the Southern District of Texas found that the contractual rate of interest must be applied.[6]

With the District of Delaware, the Southern District of Texas and the Southern District of New York being among the most popular forums for large, complex Chapter 11 filings, the fact that these courts in particular have reached different conclusions could lead to meaningful differences regarding where solvent debtors with potential post-petition interest exposure choose to file.

Over the next several years, it is a virtual certainty that other circuit-level courts will be asked to opine on the issue. In fact, the U.S. Court of Appeals for the Fifth Circuit is currently considering the same question in the Ultra Petroleum matter.

In the meantime, solvent, or potentially solvent, debtors may choose to file bankruptcy cases outside the Ninth Circuit, if possible, to avoid paying unimpaired unsecured creditors the higher rate of interest.

Additionally, both solvent debtors and unimpaired unsecured creditors to solvent debtors should be prepared to litigate the issue to the circuit level in cases maintained outside the Fifth and Ninth Circuits.

Background

PG&E was solvent before and during its bankruptcy proceedings.

Under the debtors' proposed Chapter 11 plan, members of an ad hoc committee of holders of trade claims were to be paid the full principal amount of their unsecured claims plus interest at the federal judgment rate, allegedly rendering such holders' claims as unimpaired under the plan.

The federal judgment rate, however, is materially lower than what the committee members would have been entitled to under either state law or the interest rates set forth in their respective contracts.

Specifically, the committee members alleged a $200 million discrepancy in their recoveries due to the lower rate of interest being applied.[7] Moreover, as deemed unimpaired creditors, the committee members were not even entitled to vote on the plan.

The committee and other unsecured creditors objected to the plan on the basis that unsecured creditors to solvent debtors must be paid interest on their claims at the contractual or state law rate in order to be deemed unimpaired.[8] The bankruptcy court ruled against the committee, however, finding that the lower federal judgment rate applied to their claims.[9]

The committee appealed the matter to the Northern District of California, and the district court affirmed the bankruptcy court's decision.[10]

The Ninth Circuit's Majority Decision

The Ninth Circuit began its analysis by reaffirming the common law solvent-debtor exception, which is that

a solvent debtor must generally pay postpetition interest accruing during bankruptcy at the contractual or state law rates before collecting surplus value from the bankruptcy estate.[11]

This exception was recognized under the former Bankruptcy Act, the predecessor statute to the Bankruptcy Reform Act of 1978.

Because the Bankruptcy Code, as amended, lacked any clear indication that Congress intended to abrogate the solvent-debtor exception,[12] the appellate court held that unimpaired unsecured creditors retained an equitable right to post-petition interest pursuant to their contracts or state law, and that "failure to compensate creditors according to this equitable right as part of a bankruptcy plan

results in impairment."[13]

In reaching this conclusion, the Ninth Circuit relied on, among other reasons, the Bankruptcy Code's structure. The court noted that the Bankruptcy Code provided impaired creditors with certain protections, e.g., the right to vote on a plan and the right of a dissenting impaired class to a plan that is fair and equitable.[14]

Further, the court noted that by defining impairment broadly, Congress ensured these protections would be available "to creditors whose rights were altered in any way by a plan."[15] The court reasoned that, without the solvent-debtor exception, PG&E would reap an improper windfall while steamrolling creditors' statutory and equitable rights.[16]

The Ninth Circuit also distinguished this case from past Ninth Circuit precedent. Specifically, PG&E had argued — as the bankruptcy and district courts had held — that the Ninth Circuit's 2002 ruling in In re: Cardelucci[17] set forth a broad rule that, in bankruptcy cases with a solvent debtor, all unsecured claims are entitled only to post-petition interest at the federal judgment rate.[18]

But the Ninth Circuit disagreed and clarified that

Cardelucci merely held that the phrase "interest at the legal rate" in [Section] 726(a)(5) refers to the federal judgment rate as defined by 28 U.S.C. [Section] 1961(a).[19]

Because this particular statute only applied to impaired claims, the Ninth Circuit found that Cardelucci did not resolve the issue of the rate of post-petition interest that must be paid on unimpaired claims.[20]

The court's decision in PG&E now leaves solvent debtors who file in the Ninth Circuit with two options: Use the contractual or state law rate in calculating interest on unsecured unimpaired claims, or designate such claims as impaired.[21]

Judge Ikuta's Dissent

In a dissenting opinion, U.S. Circuit Judge Sandra S. Ikuta took a distinctly different approach and went as far as to find that the Bankruptcy Code "does not authorize an award of post-petition interest to unimpaired creditors."[22]

Specifically, among other arguments, the dissent reasoned that the majority opinion "overrides the scheme set forth in the [Bankruptcy] Code," which only adopted the pre-Code solvent debtor exception in limited circumstances.[23]

In a direct response to the majority's holding, the dissent asserted that because post-petition obligations are not a part of a prepetition claim, a debtor's failure to fulfill those obligations does not result in impairment.[24]

Accordingly, the dissent found that a debtor's failure to pay post-petition interest could not retroactively make an unimpaired claim impaired.[25]

Next Steps

But this may not be the end of the story in the Ninth Circuit.

On Sept. 12, the reorganized PG&E debtors filed a petition for rehearing en banc of the August 29 decision.[26] PG&E argues that en banc review is appropriate for a couple of reasons.

First, PG&E asserted that Judge Ikuta's dissent in the Aug. 29 decision was correct that the majority decision does not follow U.S. Supreme Court precedent nor the text of the Bankruptcy Code.[27]

Second, PG&E notes that the Fifth Circuit is now considering the same question in Ultra Petroleum[28] — a case in which the bankruptcy court also found that unimpaired creditors must receive post-petition interest at the contract rate — and this is an important issue that frequently arises in solvent-debtor cases nationwide.

Indeed, if the Fifth Circuit affirms the bankruptcy court's holding, this will unify the Fifth Circuit and Ninth Circuit on this issue, in contrast to the Hertz precedent in the District of Delaware bankruptcy court.

If, however, the Fifth Circuit reverses the bankruptcy court's ruling and breaks with the Ninth Circuit, there would be a circuit split.

Conclusion

In its PG&E decision, the Ninth Circuit created the first circuit-level law on an issue that has bedeviled bankruptcy courts around the country.

Going forward, parties in interest should expect significant litigation on the issue and perhaps a circuit split that eventually finds its way to the Supreme Court.

Seth Kleinman is a partner and Miranda Russell is an associate at Morrison Foerster LLP.

Disclosure: Morrison Foerster was previously retained as special regulatory counsel to the PG&E debtors.

[1] The Ninth Circuit has appellate jurisdiction over federal courts located in Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington State.

[2] See In re PG&E Corp., No. 21-16043, 2022 WL 3712478 (9th Cir. Aug. 29, 2022).

[3] In re Hertz Corp., 637 B.R. 781, 800–01 (Bankr. D. Del. 2021).

[4] Id. at 800.

[5] See In re LATAM Airlines Grp. S.A., No. 20-11254 (JLG), 2022 WL 2206829, at *23 (Bankr. S.D.N.Y. June 18, 2022), corrected, No. 20-11254 (JLG), 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022).

[6] In re Ultra Petroleum Corp., 624 B.R. 178, 203–04 (Bankr. S.D. Tex. 2020) (unimpaired creditors must receive postpetition interest at the contract rate); see also In re Energy Future Holdings Corp., 540 B.R. 109, 124 (Bankr. D. Del. 2015) (unimpaired creditors are entitled to interest "under equitable principles" at a rate "the Court deems appropriate").

[7] See In re PG&E, 2022 WL 3712478, at *3.

[8] See In re PG&E Corp., Case No. 19-30088 (DM) (Bankr. N.D. Cal. May 15, 2020) [Docket No. 7288]; In re PG&E Corp., Case No. 19-30088 (DM) (Bankr. N.D. Cal. Nov. 8, 2019) [Docket No. 4634].

[9] See In re PG&E Corp., 610 B.R. 308, 316 (Bankr. N.D. Cal. 2019).

[10] See Off. Comm. of Unsecured Creditors v. PG&E Corp., No. 20-CV-04570-HSG, 2021 WL 2007145, at *1 (N.D. Cal. May 20, 2021).

[11] In re PG&E, 2022 WL 3712478, at *4.

[12] Id., at *11 (citations omitted).

[13] Id.

[14] Id.

[15] Id. (citations omitted and emphasis added).

[16] See id.

[17] In re Cardelucci, 285 F.3d 1231 (9th Cir. 2002).

[18] In re PG&E, 2022 WL 3712478, at *7.

[19] Id. (internal citations omitted).

[20] Id.

[21] See id.

[22] In re PG&E, 2022 WL 3712478, at *14 (Ikuta, J., dissenting).

[23] Id. at *19.

[24] Id. at *21.

[25] Id.

[26] See Petition for Rehearing En Banc (Case No. 4:20-cv-04570-HSG) [Docket No. 21-16043] (the "Petition").

[27] See Petition, at 2.

[28] See In re Ultra Petroleum Corp., No. 21-20008 (5th Cir. Jan. 5, 2021)