Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT® NOVEMBER-DECEMBER 2022

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Pratt's Journal of Bankruptcy Law

VOLUME 18 **NUMBER 8** **November-December 2022**

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)
ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2022)

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MATTHEW BENDER

(2022–Pub.4789)

Editor-in-Chief, Editor & Board of Editors

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POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

The Ongoing Solvent Debtor Debate: Divided Ninth Circuit Panel Holds that PG&E Creditors Are Entitled to Contract Rate of Interest

By Ingrid Bagby, Michele Maman, Thomas Curtin and Marc Veilleux*

In this article, the authors analyze a federal circuit court decision that underscores the disagreement among courts as to the survival of the solvent debtor exception.

The U.S. Court of Appeals for the Ninth Circuit recently held, in *Ad Hoc Comm. of Holders of Trade Claims vs. Pacific Gas and Elec. Co. (In re PG&E Corp.)*,[1] that when a debtor is solvent, a creditor may be entitled to receive interest at the contract rate (subject to equitable considerations), rather than at the federal judgment rate.

The Ninth Circuit's decision underscores the disagreement among courts as to the survival of the solvent debtor exception, including Bankruptcy Judge Walrath's recent decision in *In re The Hertz Corp*, in which the bankruptcy court held that a plan can provide unimpaired creditors with interest accruing at the federal judgment rate.

BACKGROUND

PG&E Corporation and Pacific Gas and Electric Company (the "Debtors") entered Chapter 11 in January 2019 with approximately $50 billion of known liabilities, including those arising from a series of wildfires that occurred in Northern California. On the Chapter 11 petition date, the Debtors' total assets exceeded their total amount of liabilities, and thus, the Debtors were "solvent at the time of filing" the bankruptcy petitions.

The Debtors' plan of reorganization (the "Plan") provided that unimpaired unsecured creditors would receive interest on their claims at the federal

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[1] *Ad Hoc Comm. of Holders of Trade Claims vs. Pacific Gas and Elec. Co. (In re PG&E Corp.)* (9th Cir. Aug. 29, 2022).

judgment rate of 2.59 percent. This interest rate was significantly lower than what unsecured creditors would have received under California law or under their contract rates of interest, which could accrue at a rate of 10 percent. In light of the Debtors' solvency, the Ad Hoc Committee of Holders of Trade Claims and certain other plan objectors (the "Objectors") argued that to render their claims unimpaired for purposes of Section 1124,[2] the Debtors were required to pay them interest at the rates required under their contracts or applicable nonbankruptcy law, not at the significantly lower federal judgment rate.

The U.S. Bankruptcy Court for the Northern District of California held in favor of the Debtors, reasoning that existing Ninth Circuit precedent required that all unsecured creditors of a solvent debtor were only entitled to the federal judgment rate under the Bankruptcy Code.[3] The bankruptcy court further held that even in the absence of any controlling precedent in the Ninth Circuit, the imposition of the federal judgment rate on the Objectors' claims did not render them impaired, because the Bankruptcy Code—not the Plan—imposes that rate.

The district court affirmed the bankruptcy court's decision.[4]

The Objectors appealed to the Ninth Circuit.

THE NINTH CIRCUIT'S MAJORITY DECISION

On appeal, a majority on the Ninth Circuit panel reversed the lower courts' decisions, and held that, subject to equitable considerations, solvent debtors may be required to pay unsecured creditors at the rates of interest under their contracts to render such creditors unimpaired for purposes of Section 1124 of the Bankruptcy Code. Whether a creditor is impaired has significant consequences under the Bankruptcy Code, because, for example, only impaired creditors are entitled to vote on the debtor's proposed plan of reorganization, and may raise fair and equitable challenges to the plan under Section 1129(b). Unimpaired creditors do not have these rights.

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[2] Section 1124 of the Bankruptcy Code provides that a class of claims or interests is unimpaired under a plan if the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." 11 U.S.C. § 1124(1).

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

[4] *Off. Comm. of Unsecured Creditors v. PG&E Corp.*, Case No. 20-CV-04570-HSG (N.D. Cal. May 20, 2021).

The Solvent Debtor Exception

At the heart of the *PG&E* dispute is the common law "solvent debtor exception," a doctrine that has been recently litigated in other bankruptcy cases. One important default rule in bankruptcy is that interest ceases to accrue on most claims once a bankruptcy petition is filed.[5] This rule is deemed necessary where debtors do not have sufficient resources to pay all of the claims asserted against them, and avoids scenarios in which debtors may be forced to provide disparate treatment to their creditors.

The Ninth Circuit majority observed, however, that these concerns do not exist when a debtor has "sufficient funds to pay all outstanding debts." Thus, a "solvent debtor" exception was created by eighteenth century English courts to require debtors to pay post-bankruptcy interest before the debtor could retain any residual value. American courts subsequently adopted this common law doctrine and applied it under the Bankruptcy Act of 1898 (the predecessor to the Bankruptcy Code). Although the solvent debtor exception was never codified in the Bankruptcy Act, courts nevertheless applied the doctrine to prevent solvent debtors from reaping a "windfall at their creditors' expense, pocketing money which the debtor had promised to pay promptly to the creditor."[6]

Prior Ninth Circuit Precedent Did Not Apply to Unimpaired Creditors

The PG&E court first addressed whether prior Ninth Circuit precedent abrogated the solvent debtor exception for unimpaired creditors. The lower courts relied on the Ninth Circuit's decision in *In re Cardelucci*, where the court held that unsecured debtors in a solvent debtor case are entitled to receive interest at the federal judgment rate.[7] The lower courts interpreted the *Cardelucci* decision as establishing "a broad rule that all unsecured claims in a solvent-debtor bankruptcy are entitled only to post-petition interest at the federal judgment rate, regardless of impairment status."

The Ninth Circuit disagreed, finding that its decision in *Cardelucci* "merely" stood for the proposition 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. § 1961(a)." The Ninth Circuit observed that no Bankruptcy Code section applies Section 726 of the Bankruptcy Code[8] to unimpaired claims in Chapter

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[5] 11 U.S.C. § 502(b)(2).

[6] *In re PG&E Corp., supra* n.1 (citing *Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp.*, 679 F.2d 264 (1st Cir. 1982).

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

[8] 11 U.S.C. § 726(a)(5) (providing payment of post-petition interest at "the legal rate" to

11 cases. Instead, only the best interests test of Section 1129(a)(7) incorporates Section 726(a)(5) by reference by requiring that each impaired creditor who votes against a plan must receive value "not less than . . . such holder would so receive or retain if the debtor were liquidated under chapter 7" of the Code.[9]

The Ninth Circuit held that the lower courts erred in applying *Cardelucci* to the dispute in *PG&E* because that decision analyzed Section 726(a)(5), which applies only to impaired creditors via the Chapter 11 "best interests" test.[10] Thus, the Ninth Circuit found that *Cardelucci* provides no textual basis for applying Section 726(a)(5) to unimpaired creditors; instead, *Cardelucci* merely stands for the proposition that the phrase "interest at the legal rate" in Section 726(a)(5) refers to the federal judgment rate.[11]

The Bankruptcy Code Does Not Abrogate the Solvent Debtor Exception

The Ninth Circuit next addressed whether the "solvent-debtor exception" had been abrogated by the enactment of the Bankruptcy Code in 1978. In arguing that the solvent debtor exception did not survive the enactment of the Bankruptcy Code, the Debtors relied on some recent precedent. Indeed, recent courts have found, for example, that the solvent debtor exception only survived the enactment of the Bankruptcy Code in two limited aspects: first, under Section 506(b) for oversecured creditors and second, for impaired unsecured creditors under Section 726(a)(5).[12] These courts found that because the Bankruptcy Code lacks any provision codifying the solvent debtor exception for unimpaired creditors, "[a] bankruptcy court cannot use equitable principles to modify express language of the Code," such as Section 502(b)(2), which "expressly disallows claims of unsecured creditors for unmatured interest." These courts have held that a debtor's solvency does not waive application of Section 502(b)(2), and thus there is no entitlement to interest for unimpaired creditors beyond the federal judgment rate.

But the *PG&E* majority panel departed from this precedent. The court found that even though the "solvent-debtor exception" was not explicitly codified in the Bankruptcy Code or its predecessor, there was no evidence of Congressional

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creditors, before any distribution to the debtor (or equity), in the event there are funds left after paying all other claims in a Chapter 7 liquidation case).

[9] *See* 11 U.S.C. § 1129(a)(7)(A)(ii).

[10] *In re PG&E Corp.*, *supra* n.1 ("Though our opinion in *Cardelucci* did not say so, the creditors in that case were impaired.").

[11] *Id.* (citing *In re Mullins*, 633 B.R. 1 (Bankr. D. Mass. 2021)).

[12] *Wells Fargo Bank, N.A. v. The Hertz Corp (In re The Hertz Corp.)*, 637 B.R. 781 (Bankr. D. Del. 2021).

intent to displace that common law exception. According to the court, Section 502(b)(2) of the Bankruptcy Code did not compel a different conclusion. While that section disallows claims for unmatured interest, the court found it significant that debtors also had the power to disallow such claims under the Bankruptcy Act of 1898. And, under the Bankruptcy Act, courts still employed the solvent debtor exception. Thus, the court held that the mere enactment of Section 502(b)(2) of the Bankruptcy Code provided no evidence that Congress intended to displace the solvent debtor exception.

The Ninth Circuit found that its conclusion did not conflict with the text of Section 502(b)(2). Although Section 502(b)(2) prohibits the inclusion of "unmatured interest" as part of an allowed claim, the court noted that "there is a significant distinction between whether post-petition interest can be *part of* an allowed claim" (which is covered by Section 502(b)(2)) and "whether there are circumstances under which the debtor may be required to pay post-petition interest *on* an allowed claim."[13] According to the court, payment of interest on an allowed claim is relevant to determine whether the claim is impaired for purposes of Section 1124 of the Bankruptcy Code, particularly when the debtor is solvent.

The Ninth Circuit found that the statutory history of Section 1124 of the Bankruptcy Code further supported its conclusion that the solvent debtor exception survived the enactment of the Bankruptcy Code. Specifically, Congress repealed Section 1124(3) of the Bankruptcy Code, which provided that a creditor's claim was unimpaired if it was paid "the allowed amount of [its] claim."[14] Congress repealed this section following a bankruptcy court decision in *New Valley Corp*. that strictly interpreted this provision to not require payment of any post-petition interest to render an unsecured creditor unimpaired.[15] The House Report issued in connection with the repeal of Section 1124(3) explained that the repeal was intended to avoid this "unfair result" from occurring again. According to the Ninth Circuit, this statutory history confirms "that creditors of a solvent debtor who are designated as unimpaired must receive post-petition interest on their claim—notwithstanding § 502(b)(2), or the fact that no Code provision expressly entitles such creditors to unaccrued interest."

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[13] *See In re PG&E Corp*., *supra* n.1 (citing *Mullins* (emphasis added)).

[14] Bankruptcy Reform Act of 1994, Pub. L. 103-394, § 213, 108 Stat. 4106, 4126.

[15] *See, e.g., In re New Valley Corp*., 168 B.R. 73 (Bankr. D.N.J. 1994) (holding that a creditor may be classified as unimpaired if it was paid the full principal of its claim without any post-petition interest).

Addressing the dissenting opinion (which is discussed below), the majority found that the dissent's analysis, if accepted, would yield the same exact "unfair result" reached in *New Valley Corp.*, which Congress sought to avoid by repealing Section 1124(3). The majority found that the dissent's framing of the issue as to whether unimpaired creditors are entitled to post-petition interest in the first instance "elides the antecedent question of what constitutes unimpairment in the first place." Rather, the majority found that "a more sensible reading of the Code gives solvent debtors a choice: compensate creditors in full pursuant to the solvent-debtor exception or designate them as impaired claimants entitled to the full scope of the Code's substantive and procedural protections."

Having found no evidence of Congressional intent to displace the "solvent-debtor exception," the Ninth Circuit reversed the lower court decisions. While Section 502(b)(2) did terminate the Objectors' legal rights to post-petition interest, the Objectors' claims may include "an equitable right to receive post-petition interest under the solvent-debtor exception." And to remain unimpaired for purposes of Section 1124, this equitable right may have entitled the Objectors' "to recovery of interest pursuant to their contracts, subject to any countervailing equities, before . . . shareholders received surplus value."

THE DISSENTING OPINION

Judge Ikuta of the Ninth Circuit issued a dissenting opinion, which disagreed with the majority's position that unimpaired, unsecured creditors are entitled to post-petition interest on their claims at the contract rate when the debtor is solvent. Judge Ikuta stated that the majority opinion "erroneously holds that pre-Code practice is binding unless the text of the Code clearly abrogates it." Rather, Judge Ikuta found that Congress' failure to codify the "solvent-debtor exception" indicates that there is no basis for providing unimpaired creditors with post-petition interest at the contract or state default rates.

Because Section 502(b)(2) disallows post-petition interest, Judge Ikuta observed that a claim cannot be considered "impaired" if the plan does not provide for post-petition interest at all. Judge Ikuta noted that there is "no support for the majority's conclusion" given the plain text of the Bankruptcy Code, which does not contain any express provisions providing for payment of post-petition interest on unimpaired claims. Judge Ikuta likewise found the majority's reliance on the statutory history of Section 1124(3) to be unavailing because the repeal of that section "did not provide any guidance for differentiating impaired from unimpaired claims."

Judge Ikuta found that the majority's interpretation of Section 1124(1) was flawed. According to Judge Ikuta, Section 1124(1) applies only when a claim is

impaired, not when a holder's equitable rights are altered by a plan. Section 502(b)(2) eliminates post-petition interest claims and, thus, according to Judge Ikuta, it is not plausible to read Section 1124(1) to require payment of post-petition interest to render a creditor unimpaired.

Finally, Judge Ikuta noted that the reference to "equitable rights" in Section 1124(1) did not compel a different conclusion, because any such rights can only refer rights to payment arising from equitable remedies. These "equitable rights" do not authorize a court to simply waive Bankruptcy Code provisions in light of a debtor's solvency.

KEY TAKEAWAYS

The Ninth Circuit now has joined other circuits in concluding that the solvent-debtor exception survived the enactment of the Bankruptcy Code, including the First, Fifth, and Sixth Circuit Courts of Appeals.[16] And given the survival of that exception, the Ninth Circuit found that unimpaired creditors may be entitled to receive interest at the contract rate or the rate imposed under state law, subject to equitable considerations.

However, a split exists among courts as to whether the Bankruptcy Code's silence on the treatment of unimpaired creditors entitles them to better treatment when a debtor is solvent. As the dissenting opinion in *PG&E* and Judge Walrath in Hertz found, the absence of any Bankruptcy Code provisions providing for a solvent debtor exception inhibits a bankruptcy court's ability to utilize equitable principles to override express provisions of the Bankruptcy Code, such as Section 502(b)(2). By contrast, the majority opinion in *PG&E* found that Congress' failure to expressly override the common law solvent debtor exception indicated that it did not intend to displace that doctrine.

The varying interpretations among courts reflects a difference in judicial philosophy. Some courts focus on what the Bankruptcy Code expressly allows, while others focus on what the Bankruptcy Code expressly prohibits. As the split between the majority and dissent demonstrate, competing views exist with

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[16] *See Off. Comm. of Unsecured Creditors v. Dow Corning Corp. (In re Dow Corning Corp.)*, 456 F.3d 668 (6th Cir. 2005) ("We conclude, like the other courts to have considered this issue, that there is a presumption that [contract or state law] default interest should be paid to unsecured claim holders in a solvent debtor case."); *In re Ultra Petroleum Corp.*, 943 F.3d 758 (5th Cir. 2019) ("As other circuits have recognized, absent compelling equitable considerations, when a debtor is solvent, it is the role of the bankruptcy court to enforce the creditors' contractual rights." (quotation omitted)); *Gencarelli v. UPS Cap. Bus. Credit*, 501 F.3d 1 (1st Cir. 2007) ("This is a solvent debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations . . .").

respect to this issue. Creditors should therefore be mindful that this issue is evolving, that results may vary among districts and courts, and that this issue remains unsettled in courts.