# New Bankruptcy Rulings May Give Solvent Debtors Leverage

By **Sean Scott, Aaron Gavant and Lisa Holl Chang** (October 25, 2022)

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It's black letter bankruptcy law that unsecured creditors generally are not entitled to post-petition interest in bankruptcy. But one notable exception relates to the — relatively rare — solvent debtor.

In solvent-debtor cases, in which creditors are paid in full and holders of equity interests receive a distribution, courts generally agree that unsecured creditors can receive some amount of post-petition interest.

The disagreement, in recent years, has primarily been over how much interest such unsecured creditors must receive in order to be unimpaired by a plan.

In recent opinions in the In re: Ultra Petroleum Corp.[1] and In re: PG&E Corp.[2] cases, respectively, the U.S. Court of Appeals for the Fifth Circuit and the U.S. Court of Appeals for the Ninth Circuit held that unsecured creditors in solvent-debtor cases must receive post-petition interest at the contractual rate or state judgment rate in order to be deemed unimpaired.

Dissenting judges in both cases took a different view, as did U.S. Bankruptcy Judge Mary F. Walrath in the U.S. Bankruptcy Court for the Southern District of Delaware, who recently ruled on the issue in In re: The Hertz Corp.[3]

These judges concluded that unimpaired unsecured creditors in solvent-debtor cases are only entitled to receive post-petition interest at the federal judgment rate, which is typically much lower than the contractual or state judgment rates.

**Ultra, PG&E, Hertz**

Ultra, PG&E and Hertz each present rare examples of debtors that either were solvent upon filing — insolvency is not a requirement to file for bankruptcy relief — or became solvent during the course of their bankruptcies.

Ultra filed for bankruptcy following a precipitous decline in natural gas prices. However, when commodity prices surged during the course of its case, Ultra was able to propose a plan that would pay its creditors in full.

Similarly, Hertz filed for bankruptcy in May 2020 as a result of COVID-19 travel disruptions but was able to propose a full payment plan following a successful reorganization that resulted in residual value to equityholders.

PG&E, on the other hand, did not file for bankruptcy because it was balance sheet insolvent — it was not. Instead, PG&E sought bankruptcy relief in January 2019 as a way to address massive liabilities relating to wildfires in Northern California while ensuring that it still had sufficient liquidity for its ongoing operations.

In all three cases, the debtors proposed Chapter 11 plans that would pay their unsecured creditors the principal and prepetition interest amounts of their claims in full and also pay them post-petition interest on those claims at the federal judgment rate.

The Ultra, PG&E and Hertz plans classified such claims as unimpaired, a term of art under the U.S. Bankruptcy Code, which, if correct, meant the creditors would not be entitled to vote on the plans and would not have certain other rights that impaired creditors have.

However, in all three cases, unsecured creditors objected to the proposed rate of post-petition interest, taking the position that they were entitled to their bargained-for contractual rates of interest, or in the absence of one, the state judgment interest rate.

Absent payment in full of their claims including accrued post-petition interest, the creditors argued that their claims could not be considered unimpaired.

The debtors in each case, on the other hand, took the position that payment of post-petition interest at the federal judgment rate was sufficient, that unsecured creditors were receiving all that they were entitled to receive, and that such creditors were therefore not entitled to vote on the proposed plans.

In Ultra, U.S. Bankruptcy Judge Marvin Isgur agreed with the unsecured creditors, finding that the equitable solvent-debtor exception applied, and finding that Ultra was required to pay unsecured creditors post-petition interest at the contractual or state law rates in order for such creditors to be deemed unimpaired.[4]

Recently, the Fifth Circuit affirmed that decision.

In PG&E and Hertz, the bankruptcy courts agreed with the debtors. In PG&E, this led to appeals to the district court — which agreed with the bankruptcy court — and the Ninth Circuit, which overturned the lower court decisions.

In Hertz, parties are currently seeking reconsideration of Judge Walrath's opinion.

**Analyzing the Decisions: Impaired vs. Unimpaired**

Although coming to different results, the decisions in PG&E, Ultra and Hertz all focus on the difference between impaired and unimpaired claims under a plan of reorganization.

Section 1124 of the Bankruptcy Code states that in order for a claim to be unimpaired, the Chapter 11 plan must leave "unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest."

One key aspect of impairment is that only impaired classes of creditors have the right to vote on whether to accept a plan, whereas unimpaired classes of creditors are deemed to accept a plan and do not vote.

In order for a plan to be approved on a fully consensual basis, it must be approved by all classes of impaired creditors — and even so-called cramdown plans require at least one impaired accepting class.[5]

Additionally, if an impaired class of creditors does not vote to accept a plan, a debtor must satisfy the more stringent additional requirements for confirmation set forth in Section 1129(b) of the Bankruptcy Code.[6]

**Analyzing the Decisions: Protections Given to Impaired Creditors**

Dissenting impaired creditors receive two important protections under the Bankruptcy Code that provide a statutory basis to receive post-petition interest, one that applies to creditors individually and the other that applies to them as a class.

The best interests test must be satisfied with respect to each individual dissenting creditor, and the fair and equitable requirement must be satisfied to cramdown a dissenting impaired class.

First, the best interests test[7] requires that an impaired creditor that votes against a plan receive "not less than the amount that such holder would so receive or retain if the debtor were liquidated" under Section 726. Section 726, in turn, sets forth the priority of distributions in a Chapter 7 liquidation.

Importantly, before distributions can be made to the debtor — as would occur in a solvent-debtor case — interest must be paid on allowed claims "at the legal rate from the date of the filing of the petition." Courts have typically interpreted this as the federal judgment rate.

Therefore, the best-interests test and its incorporation of Chapter 7 liquidation priorities means that a dissenting impaired creditor in a Chapter 11 solvent-debtor case must be paid interest at not less than the federal judgment rate from the date of the filing.

Second, Title 11 of the U.S. Code, Section 1129(b)(2)(B), provides that if a class of impaired creditors votes against a plan, the bankruptcy court may only confirm that plan if it is, among other things, fair and equitable with respect to that class.

Because the Bankruptcy Code does not entirely define what satisfies the fair and equitable standard in all instances, some courts have found that this standard gives courts discretion to require impaired unsecured creditors to receive post-petition interest at the contractual or even default rate in solvent-debtor cramdown cases.[8]

**To What Rate of Interest Are Unimpaired Unsecured Creditors Entitled?**

Where the decisions in PG&E, Ultra and Hertz diverge is on the question of what rate of interest must be paid to an unimpaired unsecured creditor, a topic on which the Bankruptcy Code is admittedly silent.

Intuitively, it seems that if impaired creditors must, at a minimum, receive interest at the federal judgment rate, then unimpaired creditors who are not entitled to vote on the plan should receive something greater.

The Fifth and Ninth Circuits found the basis for something greater in the solvent-debtor exception that has existed in common law from even before the Bankruptcy Code was enacted.

To see how the Fifth and Ninth Circuits reached their decisions, one must first go back to Section 1145 and what it means for a claim to be unimpaired, which is that the plan leaves unaltered the legal, equitable and contractual rights to which such claim entitles its holder.

At first glance it would seem that not paying the contractual rate of interest is an alteration

of a holder's contractual rights.

However, the Bankruptcy Code may, and in certain instances does, alter contractual rights by statute. Specifically, Section 502(b)(2) expressly disallows post-petition interest on all claims — subject to Section 506(b), which allows it for oversecured claims.

That leaves undersecured and unsecured creditors without any statutory entitlement, as part of their claims, to any post-petition interest even though, contractually, such claimants would be entitled to post-petition interest.[9] Stated another way, in the typical case, a plan does not impair an unsecured creditor's claim by failing to pay such creditor any post-petition interest.

Instead, the alteration of contract rights is done by the Bankruptcy Code itself, not the plan.

That said, the basis on which the Fifth and Ninth Circuits found that the unsecured creditors were impaired in solvent-debtor cases lies in equity.

Before Congress passed the Bankruptcy Code in 1978, courts had already established an equitable solvent-debtor exception that entitled unsecured creditors to their full contractual rates of interest in cases where a debtor had sufficient funds to pay all of its creditors in full.

This 18th century rule was an established part of bankruptcy law under the pre-code Bankruptcy Act, and the Fifth and Ninth Circuits determined that nothing about the enactment of the Bankruptcy Code abrogated it.

The U.S. Supreme Court has held that pre-Bankruptcy Code bankruptcy law may be applicable to the extent that it is not specifically overridden by the Bankruptcy Code.[10]

The debtors in the PG&E, Ultra and Hertz cases each argued that Section 502(b)(2) — which expressly disallows post-petition interest — is such an express override of the pre-Bankruptcy Code, solvent-debtor exception.

The Ninth Circuit panel, in the majority and dissenting opinions, reached different conclusions on this point.

The majority emphasized that the Bankruptcy Act also had a provision generally disallowing post-petition interest and yet the rule allowing it for unsecured creditors in solvent-debtor cases nonetheless still applied. Thus, the majority reasoned that the exception should continue to apply under the Bankruptcy Code.

Taking a heavily textual approach, the dissent disagreed, finding it only appropriate to look at pre-Bankruptcy Code common law if an answer could not be found in the express text of the Bankruptcy Code.

The dissent concluded that, because Section 502(b)(2) disallows post-petition interest, the inquiry stops there.

The fact that this reading leads to the incongruous result that impaired unsecured creditors can receive post-petition interest in solvent-debtor cases — because of the best interests and fair and equitable tests — whereas unimpaired unsecured creditors cannot, didn't change the dissent's opinion.[11]

Similar to the dissent in PG&E, the dissent in Ultra and the bankruptcy court in Hertz also

did not think that it was appropriate to look at pre-Bankruptcy Code bankruptcy law to resolve this issue.

However, unlike the dissent in PG&E, the dissenting judge in Ultra and the bankruptcy court in Hertz did not go so far as to suggest that unimpaired unsecured creditors in solvent-debtor cases should not receive any post-petition interest whatsoever.

Although the dissent in Ultra focused on the solvent-debtor exception in the context of the majority's opinion on the payment of a make-whole amount, the court in Hertz wrestled with the issue of post-petition interest and ultimately relied on legislative history to find that the federal judgment rate should apply in all instances — both to impaired and unimpaired unsecured creditors.[12]

This approach seems more pragmatic than textual, especially given the seeming contradiction in finding that the Bankruptcy Code's text must be strictly followed to deny unimpaired unsecured creditors their full contractual rate of interest while determining based on legislative history that they are still entitled to post-petition interest at the federal judgment rate.

The various views on this issue — not only between PG&E and Ultra on the one side and Hertz on the other, but also between the majority and dissenting opinions in PG&E and Ultra — cautions against any sense of certainty, absent legislative action, on how disputes on this issue in future cases will be resolved.

Unsecured creditors will undoubtedly be pleased that, with two circuit court opinions on their side, a trend arguably appears to be emerging in favor of requiring payment of post-petition interest at the full contractual or state judgment interest rates in order for such creditors to be deemed unimpaired under a plan in solvent-debtor cases.

However, solvent debtors still have the option in many jurisdictions to propose a plan that deems certain classes of creditors unimpaired — while only paying the federal judgment rate — and the differing views on the subject provide them with negotiating leverage. More to come.

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***Disclosure: Mayer Brown represented JPMorgan Chase, as administrative agent, in connection with the Ultra Petroleum bankruptcy, Barclays in the Hertz case, and*** *BNP Paribas* ***in the PG&E case.***

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[1] In re Ultra Petroleum Corporation, No. 21-20008, 2022 WL 8025329 (5th Cir. Oct. 14, 2022).

[2] In re PG&E Corp., 46 F.4th 1047 (9th Cir. 2022). The PG&E debtors petition the Ninth Circuit to grant a rehearing en banc of the decision, but such petition was denied on October

5, 2022.

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

[4] In re Ultra Petroleum Corp., 624 B.R. 178, 181-184 (Bankr. S.D. Tex. 2020).

[5] 11 U.S.C. § 1129(a)(8).

[6] 11 U.S.C. § 1129(b)(1).

[7] 11 U.S.C. 1129(a)(7)(A)(ii).

[8] See, e.g., In re Dow Corning Corp., 456 F.3d 668 (6th Cir. 2006); In re Energy Future Holdings Corp., 540 B.R. 109, 118 (Bankr. D. Del. 2015).

[9] Whether postpetition interest is allowed as part of a claim is a different question than whether postpetition interest needs to be paid to satisfy the "best-interests test" in connection with plan confirmation. See, e.g., In re Energy Future Holdings Corp., 540 B.R. 109, 111 (Bankr. D. Del. 2015) ("The Debtors are correct that UMB's allowed claim cannot include post-petition interest, i.e., "unmatured interest," because to hold otherwise would violate the plain meaning of section 502(b)(2). Furthermore, sections 726(a)(5) and 1129(a)(7)(A)(ii) do not alter the allowed amount of UMB's claim. The parties' arguments, however, miss the mark. To say that UMB's allowed claim excludes post-petition interest is the beginning of the analysis not the end. As one court has noted, there is a distinction between the payment of interest on an allowed claim as opposed to as an allowed claim. ") (emphasis in original).

[10] Cohen v. de la Cruz, 523 U.S. 213, 221 (1998); BFP v. Resol. Tr. Corp., 511 U.S. 531, 546 (1994).

[11] In addition to its reliance on the equitable solvent-debtor exception, the Fifth Circuit also concluded that an unimpaired unsecured creditor must receive at least as much as an impaired unsecured creditor. Furthermore, under the best interests test, impaired unsecured creditors must receive "not less" than what they are entitled to in a Chapter 7 liquidation. By implication, impaired unsecured creditors (and thus, unimpaired unsecured creditors) can also receive more than the federal judgment rate. In re Ultra Petroleum Corporation, No. 21-20008, 2022 WL 8025329, at *14-16 (5th Cir. Oct. 14, 2022).

[12] The Hertz court described legislative history at length in its decision. Ultimately, the decision appears to rely on the fact that Section 1129(a)(7) (the "best interests" test) used to apply to impaired and unimpaired creditors, and Congress did not indicate an intent to deprive unimpaired creditors postpetition interest when it made it only applicable to impaired creditors (rather, the point was that the plan would only be voted on by "real" creditors). Furthermore, neither the Bankruptcy Code nor legislative history provide that unimpaired creditors are entitled to more than impaired creditors in a solvent-debtor case. In re The Hertz Corp., 637 B.R. 781, 800 (Bankr. D. Del. 2021).