

Divided Ninth Circuit finds solvent debtors owe post-petition interest at applicable contract rate

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In a 2-1 ruling, the Ninth Circuit became the first circuit court to hold that the “solvent debtor exception” affords unimpaired creditors of a solvent debtor an equitable right to receive post-petition interest on the allowed amount of their prepetition claims at the applicable contract or state law interest rate. The Court remanded to the Bankruptcy Court the determination of whether compelling countervailing equitable considerations exist that warrant application of a different interest rate.

Introduction

On August 29, 2022, in a much-anticipated decision, the United States Court of Appeals for the Ninth Circuit became the latest court, and the first circuit court, to weigh in on the question of whether creditors treated as unimpaired under a solvent debtor’s plan of reorganization are entitled to post-petition interest on their allowed prepetition claims at the applicable contract or state law interest rate or the “much lower federal judgment rate.”¹ In *In re PG&E Corp.*, a majority of the Ninth Circuit panel held that the “solvent debtor exception,” which arose from common law predating the enactment of the modern Bankruptcy Code, provides creditors of a solvent debtor with an equitable right to post-petition interest at the bargained-for (or applicable state law) rate, and that such a right cannot be altered if such creditors are treated as unimpaired under section 1124 of the Bankruptcy Code absent other compelling equitable considerations.² In so ruling, the Ninth Circuit reversed decisions of the United States Bankruptcy Court for the Northern District of California (the “Bankruptcy Court”)³ and the United States District Court for the Northern District of California (the “District Court”),⁴ in which both courts interpreted an earlier Ninth Circuit decision, *In re Cardelucci*, to hold that unimpaired creditors of a solvent debtor are entitled to post-petition interest on their claims only at the federal judgment rate. The Ninth Circuit ruling comes in the wake of conflicting Bankruptcy Court decisions in the *Hertz* and *Ultra Petroleum* bankruptcy cases, and a dissent from the majority ruling could be viewed as an invitation for the Supreme Court to weigh in as well.

This client update follows our previous client updates discussing the treatment of post-petition interest in bankruptcy.⁵

Background

Pacific Gas & Electric Company (PG&E) is a California-based electric utility provider that filed for bankruptcy protection in early 2019 to resolve tens of billions of dollars of potential wildfire-related liabilities. PG&E was a rare solvent debtor that was able to reinstate its existing equity interests under its plan of reorganization and preserve material value for its shareholders. Under PG&E’s proposed—and ultimately confirmed—bankruptcy plan, certain general unsecured creditors were entitled to receive full repayment of the amount of their non-wildfire-related claims in cash, plus all

interest accruing on such claims following the date PG&E filed for bankruptcy at a rate equal to the federal judgment rate of 2.59%.⁶ Section 1124 of the Bankruptcy Code provides that a claim is impaired unless the bankruptcy plan “leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest.”⁷ PG&E’s plan classified these unsecured creditors as “unimpaired” and thereby deemed such claimants to have accepted the plan pursuant to section 1126(f) of the Bankruptcy Code.

Several parties objected to PG&E’s plan on the ground that the plan’s application of the federal judgment rate to calculate post-petition interest was incorrect and deprived unsecured creditors of additional bargained-for interest under their prepetition contracts (where such contracts provided for higher rates of interest than the federal judgment rate). The Bankruptcy Court disagreed due, in large part, to its interpretation of the Ninth Circuit’s decision in *In re Cardelucci*.⁸ In *Cardelucci*, the debtor was solvent, and while parties agreed that, by virtue of the “best interests test” set forth in section 1129(a)(7) of the Bankruptcy Code, dissenting creditors were entitled to post-petition interest on their claims under section 726(a)(5) of the Bankruptcy Code (which provides that creditors are entitled to “payment of interest at the legal rate from the date of the filing of the petition” on their claims), they disagreed as to whether the “legal rate” of interest should be calculated using the default state law rate or the lower federal judgment rate. In *PG&E I*, the Bankruptcy Court found that in *Cardelucci* “the Ninth Circuit held that in chapter 11 cases involving solvent debtors, unsecured creditors are entitled to postpetition interest at the federal judgment rate, not at contractual or state statutory rates” and that such rule is not “limited to impaired claims” but instead has “broad application” to unimpaired claims as well.⁹ The Bankruptcy Court rejected the argument that holders of unimpaired claims should receive interest on their claims at a rate different from the rate applicable to impaired claims, finding that *Cardelucci* “drew no distinction as to whether the rule it announced was confined only to impaired claims” and that the Bankruptcy Code, not the debtors’ plan, limited unimpaired creditors’ rights to post-petition interest at the federal judgment rate only.¹⁰

Certain objecting parties appealed, but the District Court affirmed the Bankruptcy Court’s opinion on similar grounds. An appeal to the Ninth Circuit followed.

The Ninth Circuit’s decision

Observing that no circuit court had previously addressed the question despite conflicting bankruptcy court decisions in *Hertz* and *Ultra*,¹¹ the Ninth Circuit found the lower court rulings to be in error and reversed. Writing for the majority, Judge Lucero¹² first analyzed the solvent debtor exception, finding that the exception, rooted in eighteenth century English common law, required debtors “to pay interest that accrued during bankruptcy before retaining value from an estate,” and that the exception was applied with regularity and “well-established” under the Bankruptcy Act (a predecessor statute to the modern Bankruptcy Code).¹³ According to the majority, the appellant’s case “revolves around the Code’s concept of impairment,” and the Court contrasted the protections afforded to impaired creditors under the Code (i.e., the right to vote on a plan, the right to receive not less than what they would receive in a liquidation, and compliance with the absolute priority rule) with the lack of any such protections afforded to unimpaired creditors.

Next, the Court held that *Cardelucci* was misinterpreted by the lower courts as applying to unimpaired creditors. Rather, the Court found that *Cardelucci* applies only to the interpretation of “at the legal rate” in section 726(a)(5) of the Bankruptcy Code, which only applies to chapter 7 debtors or to impaired chapter 11 claims via section 1129(a)(7) of the Bankruptcy Code (the best interests test). In other words, *Cardelucci* “does not apply to unimpaired claims” and “does not answer what rate of interest is required where § 726(a)(5) does not apply—including for unimpaired claims.”¹⁴

Further, the Ninth Circuit disagreed with the Bankruptcy Court’s conclusion that several provisions in the Bankruptcy Code, read together, limited unimpaired creditors’ rights to post-petition interest. Rather, the Ninth Circuit concluded not only that the solvent-debtor exception survived passage of the Bankruptcy Code (because no provisions in the Code “unambiguously displace the long-established solvent-debtor exception”),¹⁵ but that “pre-Code practice

conclusively establishes creditors' equitable entitlement to contractual postpetition interest when a debtor is solvent, subject to any other countervailing equities."¹⁶ The Court pointed to an amendment to section 1124 of the Bankruptcy Code that was passed by Congress in 1994 to repeal a provision that provided that a creditor was unimpaired "if it was paid 'the allowed amount of [its] claim'" as evidence that a creditor designated as unimpaired must receive not just the allowed amount of its claims but also "postpetition interest on their claim."¹⁷ As additional evidence, the Court referred to the protections afforded to impaired creditors under the Code that are not available to unimpaired creditors as inconsistent with the notion that both impaired and unimpaired creditors ought to be entitled to the same rate of post-petition interest on their claims.

Although the Court held that "creditors of a solvent debtor ... enjoy an equitable right to contractual or state law default postpetition interest before allocation of surplus value from a bankruptcy estate," the Court recognized that "a balance of equities" is required in order to ascertain the interest that the "plaintiffs are entitled to in this instance."¹⁸ The Court made clear that "in most solvent-debtor cases involving unimpaired creditors," bankruptcy courts should simply "enforce creditors' rights according to the tenor of the contracts that created those rights" and apply an applicable contract rate to the calculation of post-petition interest.¹⁹ Nevertheless, the possibility of "compelling equitable considerations could counsel in favor of payment of postpetition interest at a different rate" and, accordingly, even though the Court saw "no sign of any compelling equitable considerations in this case," it acknowledged the limited factual record before it and remanded the case to the Bankruptcy Court to determine what interest rate would be proper.²⁰

In her dissent from the majority, Judge Ikuta wrote that the text of the Bankruptcy Code did not entitle unimpaired creditors to *any* post-petition interest (regardless of the rate), and that "so long as the Code is clear" pre-Code practice and case law related to the solvent-debtor exception is irrelevant. Specifically, the dissent found support in section 502(b)(2) of the Bankruptcy Code for the proposition that creditors are not entitled to any interest after a debtor files for bankruptcy, and that by extension "a claim is unimpaired so long as the proposed plan gives the creditor the same legal or contractual right to payment, or right to an equitable remedy, that the creditor had as of the date the petition was filed." Citing to certain instances where the Bankruptcy Code explicitly awards post-petition interest (such as section 726(a)(5)), the dissent reasoned that the lack of an explicit provision in the Bankruptcy Code awarding post-petition interest to unimpaired creditors is indicative of Congress's intent not to provide unimpaired creditors with a right to post-petition interest on their claims.

Takeaways

The Ninth Circuit's decision is unlikely to be the final word on the question of the appropriate rate of post-petition interest applicable to claims held by unimpaired creditors of solvent debtors. Bankruptcy Court decisions in *Hertz* and *Ultra Petroleum* that address this and similar questions are currently on appeal and likely to result in district and circuit level rulings that support or depart from the Ninth Circuit's decision. Furthermore, the lengthy dissent from the Ninth Circuit majority decision could provide a basis for either disagreement with the Ninth Circuit's ruling or review by the Supreme Court. Finally, the "meme stock" phenomenon that has led to vagaries in the market value of shares of companies that file for bankruptcy could lead to an increased frequency in debtor solvency (or purported solvency), which in turn might cause the issue presented in *PG&E* to resurface in other future cases and result in further case law development.

Notably, the *PG&E* appellants are holders of trade claims against PG&E. For at least some of these claims, which do not have contractual interest rates, the appellants seek post-petition interest payable at California's state law interest rate of 10%, which significantly exceeds not only the federal judgment rate, but also the contractual interest rates under PG&E's funded debt.²¹ Following the *PG&E* example, future solvent debtor cases may also see increased focus on, and secondary market trading activity in, trade claims for which statutory interest rates apply.

In the immediate term, the decision could be read to provide support for unimpaired creditors of solvent debtors asserting not only claims for post-petition interest but also other contract²² rights, such as make-whole claims, that might be viewed as the economic equivalent of interest.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Timothy Graulich

+1 212 450 4639

timothy.graulich@davispolk.com

Marshall S. Huebner

+1 212 450 4099

marshall.huebner@davispolk.com

Darren S. Klein

+1 212 450 4725

darren.klein@davispolk.com

Angela M. Libby

+1 212 450 4433

angela.libby@davispolk.com

Brian M. Resnick

+1 212 450 4213

brian.resnick@davispolk.com

Damian S. Schaible

+1 212 450 4580

damian.schaible@davispolk.com

David Schiff

+1 212 450 3182

david.schiff@davispolk.com

Adam L. Shpeen

+1 212 450 4169

adam.shpeen@davispolk.com

Moshe Melcer

+1 212 450 3250

moshe.melcer@davispolk.com

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¹ *In re PG&E Corp.* (“PG&E III”), 46 F.4th 1047, 1051 (9th Cir. 2022).

² *Id.*

³ See *In re PG&E Corp.* (“PG&E I”), 610 B.R. 308 (Bankr. N.D. Cal. 2019), *rev’d and remanded* 46 F.4th 1047 (9th Cir. 2022).

⁴ *Off. Comm. of Unsecured Creditors v. PG&E Corp.* (“PG&E II”), No. 20-CV-04570-HSG, 2021 WL 2007145 (N.D. Cal. May 20, 2021), *rev’d and remanded sub nom. In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022).

⁵ See [It Never Hertz To Ask: Court Declines To Dismiss Make-Whole Claims, Limits Post-Petition Interest](#) (January 5, 2022); [Fifth Circuit Questions the Enforceability of Make-Whole and Postpetition Interest Claims in Bankruptcy](#) (January 28, 2019).

⁶ See 28 U.S.C. 1961(a).

⁷ 11 U.S.C. 1124(1).

⁸ See *In re Cardelucci* (“Cardelucci”), 285 F.3d 1231 (9th Cir. 2002).

⁹ *PG&E I*, 610 B.R. at 312–13.

¹⁰ *Id.* at 315.

¹¹ Compare *In re Ultra Petroleum Corp.*, 624 B.R. 178, 203–04 (Bankr. S.D. Texas 2020) (unimpaired creditors are entitled to post-petition interest at the contract rate), with *In re The Hertz Corp.*, 637 B.R. 781, 800–01 (Bankr. D. Del. 2021) (unimpaired creditors are only entitled to post-petition interest at the federal judgment rate).

¹² Judge Lucero, a senior judge for the Tenth Circuit, was sitting by designation on the Ninth Circuit.

¹³ *PG&E III*, at 1053

¹⁴ *Id.* at 1057

¹⁵ *Id.* at 1058

¹⁶ *Id.* at 1060

¹⁷ *Id.* (alteration in original).

¹⁸ *Id.* at 1064

¹⁹ *Id.*

²⁰ *Id.* (cleaned up).

²¹ See Debtors' Brief Regarding Applicable Rate of Postpetition Interest on Allowed Unsecured Claims and Joinder of PG&E Shareholders at 2, *PG&E I*, 610 B.R. 308 (Bankr. N.D. Cal. 2019) (No.19-30088-DM), ECF No. 4624 (PG&E's prepetition funded debt documents "contain varying rates of interest ranging from 2.45% to 6.05%").

²² Indeed, the decision could support claims for non-contractual rights under applicable non-bankruptcy law, such as state law interest rates, which are frequently higher than both the federal judgment rate and many contractual rates of interest.