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Ninth Circuit Holds That Unsecured Creditors of a Solvent Debtor Accrue Postpetition Interest at the Applicable Contractual or State Law Rate If Unimpaired

The Ninth Circuit Court of Appeals held that in a solvent debtor case, unsecured creditors have an equitable right to postpetition interest at the applicable contractual or state law rate in order to be deemed unimpaired. On August 29, 2022, a divided panel of the Ninth Circuit reversed two lower court decisions in the PG&E Corporation and Pacific Gas and Electric Company (“PG&E”) chapter 11 cases¹ which had held that a solvent debtor need only pay its unsecured creditors postpetition interest at the federal statutory rate for judgments rather than the underlying contractual rate as the creditors had argued.²

The Solvent-Debtor Exception

Under the Bankruptcy Code, interest stops accruing on claims as of the petition date.³ Two exceptions exist: First, the Bankruptcy Code expressly provides that over-secured creditors are entitled to postpetition interest up to the value of their collateral.⁴ Second, courts have long recognized the “solvent-debtor exception,” an equitable doctrine pursuant to which creditors of a solvent debtor may receive postpetition interest on their claims.⁵ The “solvent-debtor exception” is not codified. It exists as a common-law exception to the prohibition on a creditor’s collection of postpetition interest. The exception ensures an equitable distribution of estate assets and derives from the common-law absolute priority rule which requires that a creditor must be “made whole” before junior interests (including equity interests) receive distributions from the bankruptcy estate.⁶

Courts applying the solvent-debtor exception have disagreed on whether the applicable postpetition interest rate that must be paid on an unsecured claim to render it unimpaired is the federal judgment rate, which is typically low, or the applicable

¹ PG&E’s chapter 11 cases are captioned *In re PG&E Corp.*, No. 19-30088 (DM) (Bankr. N.D. Cal. filed Jan. 29, 2019).

² *See Ad Hoc Comm. of Holders of Trade Claims v. Pac. Gas & Elec. Co. (In re PG&E Corp.)*, No. 21-16043, 2022 WL 3712478, at *1–2 (9th Cir. Aug. 29, 2022) [hereinafter *PG&E Corp.*].

³ 11 U.S.C. § 502(b)(2).

⁴ 11 U.S.C. § 506(b).

⁵ *PG&E Corp.*, 2022 WL 3713478, at *5.

⁶ *Id.* at *6.

contractual or state law rates, which are typically higher.⁷ This issue presented itself in PG&E’s chapter 11 cases, in which the proposed plan provided that unsecured claims would receive postpetition interest at the federal judgment rate of 2.59%.⁸ Various objecting unsecured creditors argued that the plan impermissibly denied them approximately \$200 million in postpetition interest, which was the amount the creditors argued they would have received if contractual (or in the absence of such terms, state law default) interest rates applied to their claims.⁹

Relevant Case Background

PG&E is an electric and natural gas utility business operating in California.¹⁰ As a result of devastating wildfires, PG&E faced substantial wildfire-related litigation and filed for bankruptcy to resolve these liabilities. Other than the unknown wildfire liabilities, PG&E was solvent at the time of its bankruptcy, and never contested its ability to pay non-wildfire creditors in full.¹¹ PG&E proposed a chapter 11 plan (the “Plan”) that classified non-wildfire related claims as general unsecured claims and paid them in full, including payment of postpetition interest at the 2.59% federal judgment rate.¹² PG&E argued that the plan thus rendered these claims unimpaired within the meaning of section 1124(1) of the Bankruptcy Code, and that as such, the claims were deemed to accept the plan.¹³ Certain of the unsecured claimholders objected to the plan’s postpetition interest rate, arguing that application of the lower federal judgment rate, rather than the creditors’ contractual interest rate or the state law default rate (which was ten percent), deprived them of approximately \$200 million and rendered them impaired.¹⁴

The bankruptcy court ruled against the creditors. It confirmed PG&E’s plan, concluding that unsecured creditors of a solvent debtor are only entitled to postpetition interest at the federal judgment rate.¹⁵ On appeal, the district court affirmed the bankruptcy court, concluding in part that “applying a single, easily determined interest rate to all claims for post-petition interest ensures equitable treatment of creditors.”¹⁶

The Ninth Circuit Ruling

Presiding over the appeal of the district court’s ruling, a split panel of the Ninth Circuit reversed, holding that the common law solvent-debtor exception entitles unimpaired unsecured creditors to postpetition interest at the contractual or state law default rate, subject to the equities of the case.¹⁷ A plan’s failure to provide for postpetition interest according to this equitable right results in impairment.¹⁸

⁷ See *id.* at *6–7 (“No provision of the Code specifies the rate of postpetition interest a creditor must receive from a solvent debtor to be unimpaired.”).

⁸ See *PG&E Corp.*, 2022 WL 3712478, at *7 (“PG&E’s confirmed plan provided for postpetition interest on plaintiffs’ claims at the federal judgment rate – the same rate plaintiffs would be entitled to as impaired creditors.”).

⁹ See *id.* at *3.

¹⁰ *Id.* at *2.

¹¹ *Id.*

¹² See *id.* at *3.

¹³ See *PG&E Corp.*, 2022 WL 3712478, at *3.

¹⁴ See *id.*

¹⁵ *In re PG&E Corp.*, 610 B.R. 308, 318 (Bankr. N.D. Cal. 2019).

¹⁶ *Official Comm. of Unsecured Creditors v. PG&E Corp.*, No. 20-cv-04570, 2021 WL 2007145, at *3 (N.D. Cal. May 20, 2021) (citing *In re Cardelucci*, 285 F.3d 1231, 1235 (9th Cir. 2002)).

¹⁷ See *PG&E Corp.*, 2022 WL 3712478, at *12.

¹⁸ *Id.*

At the outset, the Ninth Circuit rejected the lower courts' interpretation of its prior holding in *Cardelucci*. In *Cardelucci*, the parties agreed that creditors were owed postpetition interest under section 726(a)(5) of the Bankruptcy Code¹⁹ but disagreed on the applicable rate.²⁰ The Ninth Circuit held that Congress's reference to "interest at the legal rate" in section 726(a)(5) referred to the federal judgment rate.²¹ From this, the bankruptcy and district courts in *PG&E Corp.* concluded that *Cardelucci* established a broad rule that all unsecured creditors of a solvent debtor are entitled to postpetition interest at that rate. The Ninth Circuit disagreed. It noted that the creditors in *Cardelucci* were impaired, that the decision hinged solely on the interpretation of section 726(a)(5) of the Bankruptcy Code – a provision that does not apply to unimpaired claims, and indeed only applies to chapter 11 cases through the best-interests test – and finally, that *Cardelucci* provides no textual basis to apply section 726(a)(5) to unimpaired claims.²²

The panel then analyzed the meaning of the term "impairment" under the Bankruptcy Code and how it relates to the solvent-debtor exception. Section 1124(1) provides that a claim is impaired unless a bankruptcy plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest."²³ Noting that this concept of impairment is extremely broad and was intended to capture any alteration of rights, the Ninth Circuit considered whether the unsecured creditors of PG&E held any such legal, equitable and contractual right to receive postpetition interest, and if so, at what rate.²⁴

The Ninth Circuit concluded that the long-standing solvent-debtor exception provided unsecured creditors with an equitable right to postpetition interest at the applicable contractual or state law rates.²⁵ As a result, the Ninth Circuit concluded that PG&E's plan – which applied the lower federal judgment rate to unsecured claims – altered unsecured creditors' equitable rights, rendering their claims impaired within the meaning of section 1124(1) of the Bankruptcy Code.²⁶ According to the panel, PG&E sought to "have its cake and eat it too . . . seek[ing] to pay plaintiffs the same, reduced interest rate as impaired creditors, while depriving them of the statutory protections that impaired creditors enjoy."²⁷ The Ninth Circuit acknowledged that the solvent-debtor exception is an equitable doctrine, the application of which must be weighed against other equitable considerations, and that cases might arise where payment of contractual or default interest could impair the ability of other similarly situated creditors to be paid in full.²⁸ In reversing and remanding the matter back down to the bankruptcy court, however, the Ninth Circuit cautioned it saw no sign of any "compelling equitable considerations" in PG&E's case that might

¹⁹ Section 726(a)(5) of the Bankruptcy Code establishes the priority of distributions in chapter 7 liquidations. See 11 U.S.C. § 726(a)(5). It provides that unsecured creditors are entitled to "payment of interest at the legal rate from the filing of the petition" prior to any distribution of remaining assets to the debtor. *Id.*

²⁰ *In re Cardelucci*, 285 F.3d 1231, 1233 (9th Cir. 2002).

²¹ *Id.* at 1234–35.

²² *PG&E Corp.*, 2022 WL 3712478, at *8–9.

²³ 11 U.S.C. § 1124(1).

²⁴ *PG&E Corp.*, 2022 WL 3712478, at *6.

²⁵ *Id.* at *8–11. In reaching this conclusion, the Ninth Circuit first analyzed whether passage of the Bankruptcy Code in 1978 abrogated the solvent-debtor doctrine. It agreed with the objecting creditors that the Bankruptcy Code lacked any "clear indication" that Congress meant to displace the historic exception. *Id.* at *11 ("In so holding, we join multiple sibling circuits in recognizing that the equitable solvent-debtor exception – and its core principles that creditors should be made whole when the bankruptcy estate is sufficient – persists under the Code.").

²⁶ *Id.* at *11, 13.

²⁷ *Id.* at *11.

²⁸ *Id.* at *14.

defeat the presumption that unsecured creditors were entitled to postpetition interest at the contractual or state law default rates.²⁹

Conclusion

In *PG&E Corp.*, the Ninth Circuit clarified that pursuant to the solvent-debtor exception (a) unsecured creditors possess an “equitable right” to postpetition interest, (b) absent compelling equitable considerations to the contrary, unsecured creditors were presumptively entitled to their contractual or state law interest rate, and (c) the failure to provide for postpetition interest according to this equitable right as part of a bankruptcy plan impairs the affected claims. The decision provides clarity in an area on which other Circuit Courts have yet to rule, but leaves open that another rate might apply in cases where payment of contractual or default interest could affect other similarly situated creditors to be paid in full, or where other “compelling equitable considerations” could counsel in favor of payment of postpetition interest at a different rate. In most solvent debtor cases, however, the court clearly expects that the bankruptcy court’s equitable role will be simply to enforce creditors’ rights according to the terms of the contract under which they were created. On September 12, 2022, the Debtors filed a petition with the Ninth Circuit for rehearing *en banc*, and the petition remains pending as of this writing.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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²⁹ *Id.*