SHOW ME THE MONEY: ANOTHER LOOK AT POSTPETITION INTEREST IN SOLVENT DEBTOR CHAPTER 11 CASES

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INTRODUCTION

A controversy is brewing, both in the courts and among legal commentators, regarding the proper rate of interest payable to holders of general unsecured claims in so-called "solvent debtor" cases—chapter 11 cases in which the debtor emerges as a solvent entity.[1] Interest rates for moneys advanced in commercial lending transactions, whether under a bond indenture or a bank credit facility, have been considerably higher in recent years than the federal judgment rate, which courts traditionally have applied to calculate postpetition interest owed on account of unsecured claims.[2] Depending on the

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[1] The appropriate rate of postpetition interest has been the subject of litigation in several recent bankruptcy mega-cases, including those of Adelphia Communications Corp., Case No. 02-41729 (REG), and Loral Space & Communications Ltd., Case No. 03-41710 (RDD), both filed in the Southern District of New York, as well as that of Mirant Corp., Case No. 03-46590 (DML), filed in the Northern District of Texas. *See also* Carmen H. Lonstein & Steven A. Domanowski, *Payment of Post-Petition Interest to Unsecured Creditors: Federal Judgment Rate Versus Contract Rate*, 12 AM. BANKR. INST. L. REV. 421 (2004).

[2] As a matter of federal law, "[i]nterest shall be allowed on any money judgment in a civil case recovered in a district court." 28 U.S.C. § 1961(a) (2000). Because a bankruptcy court is a unit of the district court, this provision applies to judgments entered by a bankruptcy court. *See id.* § 151. Interest on such judgments accrues from the date the judgment is entered "at a rate equal to the weekly average 1-year constant maturity Treasury yield, as published by the Board of Governors of the Federal Reserve System, for the calendar week preceding." *Id.* § 1961(a). From April 2001 through September 2005, the federal judgment rate remained below four percent, and as of year end 2005, had not exceeded 4.5 percent per annum. *See* Market Yield on U.S. Treasury Securities at 1-Year Constant Maturity Monthly Frequency, http://www.federalreserve.gov/releases/h15/data/Monthly/H15_TCMNOM_Y1.txt (last visited Feb. 1, 2008) (listing historical data regarding federal judgment rates). From January 2006 through June 2007, the federal judgment rate generally hovered between 4.5 and 5 percent, while in the second half of 2007, it receded toward the four percent range. *See* Market Yield on U.S. Treasury Securities at 1-Year Constant Maturity Business Day Frequency, http://www.federalreserve.gov/releases/H15/data/Business_day/H15_TCMNOM_Y1.txt (last visited Feb. 1, 2008). In contrast, prime lending rates during these periods—for which most distressed borrowers would not

depth of a debtor's claim pool, the amount of money at stake in this controversy can be substantial. For example, in a 24-month bankruptcy case in which the debtor has outstanding $1 billion of unsecured bonds bearing an 8.5 percent interest rate, and where the governing federal judgment rate is two percent, use of the contract rate, as opposed to the federal judgment rate, results in an incremental cost to the debtor of approximately $130 million. It is not surprising, therefore, that holders of contract-based claims would vigorously demand payment of postpetition interest at the higher contract rate.[3] As discussed in greater detail below, notwithstanding the substantial amount of contrary case law, the terms of the Bankruptcy Code[4] do not mandate the application of the federal judgment rate in solvent debtor situations, and, in fact, appear to afford bankruptcy courts a substantial amount of discretion in determining how much interest is owed on account of general unsecured claims.

I. BACKGROUND

A. The "Solvent Debtor" Exception

In chapter 11 bankruptcy proceedings, holders of general unsecured claims typically are not entitled to payment of interest that accrues in respect of such claims on and after the date of the debtor's bankruptcy filing. The practice of disallowing postpetition interest is rooted in § 502(b) of the Bankruptcy Code, which provides in relevant part:

> (a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects.
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> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the

qualify—were consistently around 300 basis points higher. *See* Average Majority Prime Rate Charged by Banks on Short-Term Loans to Business, http://www.federalreserve.gov/releases/h15/data/Monthly/H15_PRIME_NA.txt (last visited Feb. 1, 2008).

[3] See, for example, the chapter 11 cases of Adelphia Communications Corp, Case No. 02-41729 (REG) and Loral Space & Communications Ltd., Case No. 03-41710 (RDD), both filed in the U.S. Bankruptcy Court for the Southern District of New York, and Mirant Corp., Case No. 03-46590 (DML), filed in the U.S. Bankruptcy Court for the Northern District of Texas.

[4] The term "Bankruptcy Code" as used herein refers to Title 11 of the United States Code, as amended. Unless otherwise specified, all references to numbered sections are references to sections of the Bankruptcy Code.

> petition, and shall allow such claim in such amount, except to the extent that . . . (2) *such claim is for unmatured interest*.[5]

Under what commonly is referred to as the "solvent debtor" exception, however, a debtor that proves to be solvent[6] in the course of a chapter 11 case generally is required to pay postpetition interest, even on its prepetition general unsecured obligations.[7] The premise behind this exception is the deep-rooted principle that it would be "inequitable" to permit shareholders to retain any value before creditors are made whole.[8] That rule, which originally was judge-made, eventually was incorporated by statute into chapter 7 of the Bankruptcy Code (the liquidation chapter), but not expressly into chapter 11 (the reorganization chapter).[9] Section 726(a)(5), which embodies the solvent debtor exception, provides a fifth priority of distribution in a chapter 7 case to "interest at the legal rate from the date of the filing of the petition" on all creditors' claims.[10] Section 726(a)(6), in turn, provides a sixth priority of distribution to equity holders.[11] Although the solvent debtor exception is not expressly incorporated into chapter 11 of the Bankruptcy Code, bankruptcy courts consistently have applied that rule in chapter 11 cases, albeit through varying legal theories, as described below.

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5 11 U.S.C. § 502(a)–(b) (emphasis added).

6 A solvency analysis invokes Bankruptcy Code § 101(32), under which a corporate entity is *insolvent* if "the sum of such entity's debts is greater than all of such entity's property, at a fair value, exclusive of (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors[,] and (ii) property that may be exempted from property of the estate under section 522 of this title . . . ." *Id.* § 101(32). This test, essentially, is a balance sheet test. *See, e.g.*, Dunlavey v. Uhlmeyer (*In re* Uhlmeyer), 67 B.R. 977, 980 (Bankr. D. Ariz. 1986) (noting that insolvency is determined using a balance sheet test).

7 *See*, *e.g.*, *In re* Mirant Corp., 327 B.R. 262, 271 (Bankr. N.D. Tex 2005) (indicating that postpetition interest must be paid in connection with prepetition general unsecured claims in solvent debtor situations); *In re* Schoeneberg, 156 B.R. 963, 969 (Bankr. W.D. Tex. 1993) (same).

8 Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 164–65 (1946) ("[W]here an estate was ample to pay all creditors and to pay interest even after the petition was filed, equitable considerations were invoked to permit payment of this additional interest to the secured creditor rather than to the debtor."); Consol. Rock Prods. Co. v. DuBois, 312 U.S. 510, 527 (1941) ("Whether a company is solvent or insolvent in either the equity or the bankruptcy sense, 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights' of creditors 'comes within judicial denunciation'. [sic]" (quoting Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899))); Am. Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., 233 U.S. 261, 266–67 (1914); Johnson v. Norris, 190 F. 459, 463 (5th Cir. 1911); *Schoeneberg*, 156 B.R. at 971–72.

9 *See, e.g.*, *In re* Shaffer Furniture Co., 68 B.R. 827, 829 (Bankr. E.D. Pa. 1987), *abrogated by In re* Chiapetta, 159 B.R. 152 (Bankr. E.D. Pa. 1993).

10 11 U.S.C. § 726(a)(5).

11 *Id.* § 726(a)(6).

Notwithstanding the relative consensus that has developed regarding the validity of the solvent debtor exception, there has been a substantial amount of disagreement in recent years as to what rate should be applied to calculate the amount of interest owed to unsecured creditors. Courts traditionally have applied the federal judgment rate, not only with respect to trade claims and other claims that have no agreed-upon rate of interest,[12] but also with respect to contract-based claims, such as those arising under a credit agreement or a bond indenture.[13] Recently, however, an increasing number of courts—including in high-profile chapter 11 bankruptcy mega-cases such as *Loral Space & Communications* and *Mirant Corp.*[14]—have applied the contract rate of interest to determine the amount of interest owed in solvent debtor situations.

In order to fully understand the differences between the traditional approach to calculating postpetition interest and this revised approach, it is important first to understand the confirmation requirements contained in § 1129 of the Bankruptcy Code.

B. Relevant Bankruptcy Principles

Under the Bankruptcy Code, a chapter 11 debtor may formulate a plan of reorganization containing a proposed treatment of creditors' claims.[15] A bankruptcy court, in turn, may confirm the proposed chapter 11 plan if it concludes that each of the requirements set forth in § 1129 have been satisfied. One such requirement is the satisfaction of the "best interests of creditors" test in § 1129(a)(7), which provides that:

> With respect to each impaired class of claims or interests . . . each holder of a claim or interest of such class [must either] (i) [have] accepted the plan; or (ii) . . . receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date . . . .[16]

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[12] *See, e.g.*, *In re* Dow Corning Corp., 270 B.R. 393, 404 (Bankr. E.D. Mich. 2001) (finding that a trade claim was entitled to postpetition interest at federal judgment rate).

[13] *See, e.g.*, Onink v. Cardelucci (*In re* Cardelucci), 285 F.3d 1231, 1233 (9th Cir. 2002) (concluding that "11 U.S.C. § 726(a)(5) *mandates* application of the federal interest rate" (emphasis added)).

[14] *See supra* note 1.

[15] 11 U.S.C. § 1121(a) ("The debtor may file a plan . . . at any time in a voluntary case or an involuntary case.").

[16] *Id.* § 1129(a)(7).

Under this test, a debtor cannot confirm a chapter 11 plan unless each holder of an impaired[17] claim either has accepted the plan or will receive under the plan at least what it would receive under a hypothetical chapter 7 liquidation. As discussed above, § 726, which sets forth the distributional priority scheme applicable in chapter 7 liquidation cases, provides in subsection (a)(5) that a solvent debtor that liquidates under chapter 7 is required to pay postpetition interest to general unsecured creditors at "the legal rate" before making any distributions to junior stakeholders.[18]

In addition to the best interests of creditors test, another confirmation requirement in § 1129(a) is that each class of claims or interests must either have voted to accept the proposed chapter 11 plan or have been rendered unimpaired under the plan.[19] In the event that one or more classes of claims or interests has voted to reject the plan—but the plan satisfies all of the remaining conditions of § 1129(a)—a bankruptcy court nevertheless may confirm the plan in a "cramdown" under § 1129(b), if it finds, among other things, that the plan is "fair and equitable" with respect to each class of claims or interests that is impaired under, and has not voted to accept, the plan.[20] The fair and equitable requirement set forth in § 1129(b) primarily is designed to incorporate into the Bankruptcy Code what commonly is referred to as the "absolute priority rule," which embodies the concept that "the stockholder's interest in the property is subordinate to the rights of creditors[;] [f]irst of secured, and then of unsecured, creditors . . . to the extent of their *debts* creditors are entitled to priority over stockholders against all the property of an insolvent corporation."[21] Thus, the absolute priority rule requires that creditors

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[17] Under § 1124(1) of the Bankruptcy Code, a class of claims is deemed impaired unless, with respect to each claim in that class, the chapter 11 plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." *Id.* § 1124(1). Similarly, under Bankruptcy Code § 1124(2), a class of claims generally will be found to be unimpaired if the debtor cures any defaults, reinstates the maturity of those claims, compensates the holders for related damages, and otherwise leaves unaltered the legal, equitable, or contractual rights attendant to such claims. *Id.* § 1124(2).

[18] *See supra* notes 10–11 and accompanying text.

[19] 11 U.S.C. § 1129(a)(8).

[20] *Id.* § 1129(b). Due to the structure of § 1129(b) of the Bankruptcy Code, the fair and equitable principle applies only to impaired classes that have voted to reject the plan. As a practical matter, however, unsecured creditors seeking to enhance the amount of postpetition interest awarded to them under a plan of reorganization would use § 1129(b) as leverage to negotiate a better deal with the debtor or any other plan proponent. If negotiations prove to be unsuccessful, unsecured creditor classes can make § 1129(b) relevant in the confirmation process by voting to reject the plan.

[21] Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 116 (1939) (emphasis added) (quoting Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899), and Kan. City Terminal Ry. Co. v. Cent. Union Trust Co., 271 U.S. 445, 455 (1926)).

be paid in full, including postpetition interest, before equity holders may participate in any recovery.[22] It is notable that this rule, as articulated in *Case v. L.A. Lumber*, relates to the priority in payment of all of a senior creditor's "debts" as opposed to merely the amount of the creditor's allowed claim.[23]

II. DISCUSSION

A. *The Traditional Approach to Calculating Postpetition Interest*

Courts that have applied the federal judgment rate uniformly to calculate the amount of postpetition interest owed in solvent debtor cases often begin and end their analysis with the best interests of creditors test contained in § 1129(a)(7) of the Bankruptcy Code. In doing so, courts have reasoned that under the hypothetical liquidation scenario contemplated under § 1129(a)(7), which incorporates by reference the distribution scheme set forth in § 726(a)(5),[24] a solvent debtor would be required to pay postpetition interest to general unsecured creditors at "the legal rate" before making any distributions to junior stakeholders.[25]

Because the Bankruptcy Code fails to provide a definition for the term "the legal rate," courts were left to determine what the applicable rate should be, and in the process, considered the practical implications of applying a uniform rate as opposed to rates that vary by claim. One of the principal concerns raised by courts was that applying varying interest rates would in many instances disproportionately benefit some creditors at the expense of others:

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[22] *In re* Rocha, 179 B.R. 305, 306–07 (Bankr. M.D. Fla. 1995) ("The absolute priority rule, in its simplest terms, requires that creditors of a debtor in bankruptcy reorganization receive payment of their claims in their established order of priority, and that they receive payment in full before lesser interests—such as those of [debtors-in-possession]—may share in the assets of the reorganized entity.") (internal citations omitted); 140 CONG. REC. H10,752, H10,768 (daily ed. October 4, 1994); *see also* Solow v. PPI Enters. (U.S.) (*In re* PPI Enters. (U.S.)), 324 F.3d 197, 205 n.14 (3d Cir. 2003); Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp., 679 F.2d 264, 269 (1st Cir. 1982) (applying solvent debtor exception by way of Bankruptcy Act version of fair and equitable test).

[23] *See Case*, 308 U.S. at 116; *see also* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) ("[T]he absolute priority rule provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan." (alteration in the original) (internal quotations omitted)); N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 505 (1913) (noting in a case involving a railroad foreclosure, "[a]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation").

[24] *See supra* text accompanying notes 15–18.

[25] 11 U.S.C. § 726(a)(5).

> The problem [with utilizing varying rates] . . . is that different creditors will have different rates of interest, depending upon their contracts or the applicable statutory rate. One contract might provide for interest at 18%, another at 9%. . . .
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> Quite often . . . there are only enough assets to pay *some* interest to creditors, *not* enough to pay *all* creditors *all* the interest they claim at their contract or statutory rates. Using those rate [sic], some creditors would receive a disproportionately large percentage of the remaining assets compared to their underlying unsecured claims, to the prejudice not of the debtor, but of other, otherwise equally situated, unsecured creditors.[26]

In addition, courts reasoned that application of a uniform interest rate would be far easier to administer, promote a universal resolution in bankruptcy cases across the country, and be more cost effective.[27] Courts also took note that Congress expressly had opted for the language in § 726(a)(5) to read "interest at *the* legal rate" as opposed to "*a* legal rate," and concluded that this choice in wording was indicative of a policy preference for applying a single uniform rate as opposed to having different rates for different claims.[28] As a result, courts traditionally applied the federal judgment rate when awarding postpetition interest in solvent debtor cases, based upon the rationale that "federal law [should] decide a federal issue."[29]

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[26] *In re* Melenyzer, 143 B.R. 829, 832 (Bankr. W.D. Tex. 1992) (emphasis in original).

[27] *See, e.g.*, *In re* Godsey, 134 B.R. 865, 866–67 (Bankr. M.D. Tenn. 1991); *see also* Beguelin v. Volcano Vision, Inc. (*In re* Beguelin), 220 B.R. 94, 101 (9th Cir. BAP 1998). In further support of utilizing the federal judgment rate, courts have analogized bankruptcy claims to federal judgments. *See Melenyzer*, 143 B.R. at 833 ("From and after the petition date, . . . creditors hold the equivalent of a federal judgment against estate assets, enforceable only in federal court."); *In re* Cardelucci, 285 F.3d 1231, 1235 (9th Cir. 2002) ("As of the date of the filing of the petition, creditors hold a claim, similar to a federal judgment, against the estate, the payment of which is only dependent upon completion of the bankruptcy process.").

[28] *E.g.*, *Cardelucci*, 285 F.3d at 1234 (emphasis added) ("[P]rinciples of statutory interpretation lend strong support to the conclusion that Congress intended 'interest at the legal rate' in 11 U.S.C. § 726(a)(5) to mean interest at the federal statutory rate pursuant to 28 U.S.C. § 1961(a)."); *Beguelin*, 220 B.R. at 100 ("[T]he federal judgment rate is the appropriate measure of interest under § 726(a)(5) . . . .").

[29] *Melenyzer*, 143 B.R. at 833. A small minority of cases have applied the state judgment rate as opposed to the federal judgment rate. *See, e.g.*, Boyer v. Bernstein (*In re* Boyer), 90 B.R. 200, 201 (Bankr. D.S.C. 1988). However, the policy considerations that inspired courts to adopt the federal judgment rate (i.e., ratable distribution to creditors, ease of administration, uniformity of resolution, and cost efficiency) are not addressed by the application of the state judgment rate given that claims against the debtor invariably will be governed by varying laws—and therefore, varying rates of interest.

B. *Basis for the Revised Approach*

While the traditional approach is appealing for its simplicity and ease of application, the analysis underlying this approach appears flawed for two important reasons. First, contrary to the repeated admonitions of the United States Supreme Court that the Bankruptcy Code must be applied in accordance with its plain meaning,[30] this analysis strays from the express terms of § 1129(a)(7), as it purports to establish the *specific* rate of interest that must be paid, rather than merely the *minimum* that must be paid. As discussed above, the best interests of creditors test requires that a non-assenting creditor receive "not less than" the amount it would receive in a hypothetical chapter 7 liquidation; it does not specify an amount (or rate) that a non-assenting creditor must receive under a proposed plan. Therefore, § 1129(a)(7) should not be interpreted to *require* the application of the federal judgment rate.

Second, an analysis that relies solely on the best interests of creditors test does not go far enough, as it fails to consider the impact of the fair and equitable test contained in § 1129(b).[31] As discussed above, application of the fair and equitable test invokes the absolute priority rule, which requires that non-consenting classes of claims or interests be made whole (i.e., paid in full, including, arguably, interest at the bargained-for rate) before junior stakeholders can receive any distribution.[32] Under well-established principles of statutory construction, the best interests of creditors test must be reconciled with the fair and equitable test, and both of those statutory provisions must be given meaning.[33] The result is that while the best interests of creditors test may establish a floor for what interest must be paid, the fair and equitable test will, in many instances, permit the payment of interest at a higher rate,

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[30] *See* Lamie v. U.S. Tr., 540 U.S. 526, 534 (2004) ("It is well established that 'when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.'" (quoting Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6 (2000))); United States v. Ron Pair Enters., Inc., 489 U.S. 235, 241 (1989).

[31] *See In re* Dow Corning Corp., 270 B.R. 393, 406 (Bankr. E.D. Mich. 2001) (noting that under Bankruptcy Code § 1129(b), "the plan proponent must establish that the plan is fair and equitable to a nonaccepting, impaired class, even though the plan provides for payment to that class of postpetition interest at the § 726(a)(5)—mandated federal judgment rate").

[32] Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 116 (1939) ("'[T]o the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation.'" (quoting Kan. City Terminal Ry. Co. v. Cent. Union Trust Co., 271 U.S. 445, 455 (1926))).

[33] *See Dow Corning*, 270 B.R. at 401 ("Courts have the 'duty to give effect, if possible, to every clause and word of a statute.'" (quoting Duncan v. Walker, 533 U.S. 167 (2001))); *see also* Williams v. Taylor, 529 U.S. 362, 364 (2000) (describing this rule as a "cardinal principle of statutory construction").

particularly when the higher rate is set forth in a contract between the debtor and a creditor.[34]

Courts recently have recognized that in determining what the appropriate rate of interest is in solvent debtor situations, the fair and equitable test must be applied in conjunction with the best interests of creditors test. For example, in *Dow Corning*, the United States Court of Appeals for the Sixth Circuit held that under § 1129(b), the postpetition interest awarded to the unsecured creditors in that case must be calculated using the contract rate of interest.[35] In addition, the United States Bankruptcy Court for the Southern District of New York, in the consolidated chapter 11 bankruptcy cases of *Loral*, observed that the fair and equitable standard embodied in § 1129(b) must be determined alongside the best interests of creditors test.[36] On that basis, the *Loral* court held that creditors of a Loral affiliate that had been found to be solvent would have been entitled to postpetition interest at the non-default contract rate.[37]

As the bankruptcy court in *Loral* observed, this revised approach grants bankruptcy courts a substantial amount of discretion in determining the amount of postpetition interest owed to general unsecured creditors in solvent debtor situations.[38] The bankruptcy court, on the one hand, is not bound to apply the federal judgment rate because the fair and equitable principle permits the court to award postpetition interest at a greater amount. On the other hand, the absolute priority rule, an inexact concept that requires "payment in full" of senior creditors, also falls short of requiring the bankruptcy court to apply any

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[34] *Dow Corning*, 270 B.R. at 406 ("[Section] 726(a) does not supplant or otherwise invalidate a chapter 11 creditor's contractual right to postpetition interest.").

[35] *Id.*

[36] *See* Bench Ruling, at 41, *In re* Loral Space and Commc'ns Ltd., No. 03-41710 (Bankr. S.D.N.Y. July 25, 2005).

[37] *Id.* As the bankruptcy court pointed out, however, the six percent interest rate that was applied to calculate the postpetition interest awarded under the Loral Plan was not the governing contract rate, but was a compromise entered into amongst the general unsecured creditors, which was higher than the applicable federal judgment rate, but was less than the governing contract rate. *Id.* at 42.

[38] The *Loral* court observed:

> In my view, given that fair and equitable basis, and going back to the *Vanston Bondholders* case, which expressly noted that "It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor," [citation omitted], the court has a large amount of discretion in deciding what the appropriate rate of interest should be under a Chapter 11 plan for a solvent debtor.

Id. at 39–40; *but see Dow Corning*, 456 F.3d at 679 ("When a debtor is solvent, then, the presumption is that a bankruptcy court's role is merely to enforce the contractual rights of the parties, and the role that equitable principles play in the allocation of competing interest is significantly reduced.").

particular rate in calculating the amount of postpetition interest due. In light of this dynamic, bankruptcy courts that have followed this revised approach have taken account of varying factors in determining what the appropriate rate of postpetition interest is with respect to any particular case.[39]

C. Common Factors for Consideration

1. Protection for Competing Creditors

The most commonly offered rationale for applying the federal judgment rate in relation to contract-based debt is the "fairness" principle that no single creditor should receive a disproportionate share of the debtor's remaining assets to the detriment of other unsecured creditors.[40] Where a debtor is solvent but its assets are insufficient to pay creditors the full amount of postpetition interest owed under applicable non-bankruptcy law, if a uniform interest rate is not utilized, holders of debt governed by relatively higher rates of interest would benefit at the expense of creditors holding lower interest bearing (but otherwise *pari passu*) obligations.[41] Indeed, as discussed above, the potential prejudice to holders of lower interest bearing claims was one of the principle reasons the term "the legal rate"—as used in § 726(a)(5)—was interpreted to be the federal judgment rate in the first instance.[42]

For illustrative purposes, assume that company X owes $10 million in principal amount of prepetition general unsecured debt and is determined to have $11 million in assets. Of the $10 million in obligations, $5 million is

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[39] *See, e.g.*, In re Coram Healthcare Corp., 315 B.R. 321, 346 (Bankr. D. Del. 2004) ("[W]e conclude that the specific facts of each case will determine what rate of interest is 'fair and equitable.'").

[40] *See In re* Laymon, 117 B.R. 856, 861 (Bankr. W.D. Tex. 1990), *rev'd sub nom.* Bradford v. Crozier (*In re* Laymon), 958 F.2d 72 (5th Cir. 1992) ("There is no good reason why one unsecured creditor should receive a greater share of the Section 726(a)(5) 'pie' solely by virtue of its *pre*petition contract interest rate when the rationale for paying interest under Section 726(a)(5) has nothing to do with the prepetition contracts of the debtor." (emphasis in original)).

[41] Although a creditor holding a trade claim could object that payment of a higher interest rate to a contract claimant discriminates unfairly, in contravention of Bankruptcy Code § 1123(a)(4), this argument is misplaced. Section 1123(a)(4) requires that a chapter 11 plan must "provide the same treatment for each claim or interest of a particular class" unless the claimant consents to less favorable treatment. 11 U.S.C. § 1123(a)(4) (2000). This requirement is satisfied by the revised approach suggested by this article since each unsecured claimant would receive the same treatment: interest at the contract rate if a contract exists, and if there is no contract, interest at the federal judgment rate. *See id.* This approach is faithful to the well-established bankruptcy principle that property rights are generally defined by state law. *See* Butner v. United States, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.").

[42] *See supra* note 26 and accompanying text.

contract-based debt and $5 million is trade debt. If the federal judgment rate were to apply to all of the company's prepetition obligations, holders of the trade debt would share equally with holders of the contract-based debt in the debtor's estate. For example, if the postpetition interest owed on account of the company's prepetition debt is determined to be $2 million using the federal judgment rate (in which case the aggregate amount owed by the debtor would be $12 million), holders of trade debt would receive $5.5 million, as would the holders of the contract-based debt.

If, however, the governing contract rate were to apply with respect to contract-based debt, the federal judgment rate were to apply to the trade debt,[43] and postpetition interest owed on account of the contract-based debt is determined to be $2 million rather than $1 million, holders of the trade debt, which is otherwise *pari passu* with the contract-based debt, would receive less as a result of the application of the governing contract rate than they would if the federal judgment rate were applied across the board. More specifically, under this scenario, prepetition claimants would first receive $10 million on account of the principal amounts owed ($5 million to holders of contract-based debt and $5 million to holders of trade debt). The remaining $1 million would presumably be divided up amongst the creditors in proportion to the postpetition interest owed, which, as described above, would be $2 million on account of contract-based debt, and $1 million on account of the trade debt. Consequently, holders of the contract-based debt would receive approximately $5.67 million, while the holders of the trade debt would receive approximately $5.33 million. This is compared to the $5.5 million that each would receive if the federal judgment rate were applied universally.

As the *Loral* bankruptcy court noted, however, the rationale of protecting competing creditors does not apply where the interest rate dispute is between creditors and shareholders.[44] Where the debtor's estate is fully solvent (i.e., the debtor's assets are sufficient to pay all of the postpetition interest owed to unsecured creditors in full), the focus turns to what rate a contract-based claimant must receive to be made whole. For instance, in the scenario described above, if the enterprise value of company X is determined to be $13 million rather than $12 million, holders of the trade debt would receive the full amount of postpetition interest owed to them at the federal judgment rate and,

[43] *See In re* Dow Corning Corp., 270 B.R. 393, 404 (Bankr. E.D. Mich. 2001).

[44] Bench Ruling, *supra* note 36, at 41 (rejecting *Cardelucci* as precedent because that case involved an interest rate dispute amongst creditors, rather than between creditors and shareholders).

therefore, would not be adversely affected by the application of the contract rate of interest to contract-based debt. Under those facts, the only parties likely to object to payment of the contract rate are the holders of junior interests, such as holders of subordinated debt and shareholders.

Although payment of the higher postpetition contract rate interest would, of course, negatively impact the equity holders of company X (for example, if the company's prepetition creditors were merely owed $2 million in postpetition interest, equity would retain $1 million of the company's value), that is not one of the equitable considerations that militates in favor of the federal judgment rate. As mentioned above, the absolute priority rule requires payment in full of creditors' claims before equity is permitted to retain any value in the debtor's estate.[45] Based on that principle, one bankruptcy court held that "if the solvent estate produces a sufficient surplus from which to pay interest in full to all claimants at the rates prescribed [by the] underlying agreements, contracts or judgments, then that is the interest rate that should be applied by the Court."[46] Another bankruptcy court remarked: "The only good reason for refusing to give a creditor in reorganization all that he bargained for when he extended credit is to help other creditors, the debtor's assets being insufficient to pay all creditors in full."[47]

As further evidence that application of the federal judgment rate in previous rulings was not motivated by concerns over the fate of equity holders, some courts have espoused the "second cut" approach. Under this approach, any value remaining in the debtor's estate after payment of postpetition interest at the federal judgment rate would be used to pay the deficiency owing to holders of contract-based debt after taking into account the governing contract rate.[48] The "second cut" approach thus seeks to attain a fair and equitable result by first considering the interests of competing creditors, and then considering the rights of creditors vis-à-vis those of shareholders. The "second

[45] *See supra* notes 21–22 and accompanying text.

[46] *In re* Carter, 220 B.R. 411, 417 (Bankr. D.N.M. 1998). *See also In re* Fast, 318 B.R. 183, 192 (Bankr. D. Colo. 2004) (explaining that where all creditors are being paid full amount of postpetition interest, applying a rate lower than that provided by contract would be inappropriate).

[47] *Dow Corning*, 244 B.R. at 695 (quoting *In re* Chi., Milwaukee, St. Paul and Pac. Ry. Co., 791 F.2d 524, 527 (7th Cir. 1986)); *see also In re* Melenyzer, 143 B.R. 829, 832 (Bankr. W.D. Tex. 1992) (noting that equitable consideration of ensuring that no single creditor receives a disproportionate share of estate assets to detriment of others is inapplicable where assets are sufficient to pay all claims for interest in full).

[48] *In re* Laymon, 117 B.R. 856, 862–63 (Bankr. W.D. Tex. 1990), *rev'd*, 958 F.2d 72 (5th Cir. 1992); *see also Melenyzer*, 143 B.R. at 834 (criticizing the "second cut" approach, but conceding that "this approach would work in cases where the estate is sufficiently solvent to pay every unsecured creditor the full amount of interest due under state law or according to the terms of their prepetition contracts").

cut" approach awards contract rate interest for contract-based claims only when such an award will not diminish the recovery of competing creditors.

The tendency of courts to favor the agreed-upon rate of interest when competing creditors are not materially prejudiced by the application of that rate is further evidenced in cases applying § 506(b) of the Bankruptcy Code. Section 506(b) requires payment of postpetition interest to holders of oversecured claims—that is, claims secured by collateral having value in excess of such claims.[49] An oversecured creditor situation is analogous to a solvent debtor scenario, because in both instances, the debtor possesses excess value that it must first use to make certain creditors whole. Moreover, although the allowance of postpetition interest in oversecured creditor situations is governed expressly by § 506(b), the statute is silent as to the applicable rate of interest leaving that issue to be determined by the courts—just as is the case in solvent debtor situations.

In cases involving § 506(b), there is a presumption in favor of applying the contract rate of interest—including default rate interest to the extent provided for in the underlying agreement—subject to rebuttal based upon "fairness" considerations.[50] One situation in which courts consistently have declined to award the default rate of interest is where doing so would have diminished the recovery of junior creditors.[51] Such a situation would exist where the value of the secured creditor's collateral is sufficient to entitle the creditor to postpetition interest under § 506(b), but the value of the debtor's estate is insufficient to pay prepetition creditors in full. In solvent debtor situations, however, where even general unsecured creditors recover the full amount of

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[49] Section 506(b) of the Bankruptcy Code provides:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

11 U.S.C. § 506(b) (2000).

[50] *See* Southland Corp. v. Toronto-Dominion (*In re* Southland Corp.), 160 F.3d 1054, 1059–60 (5th Cir. 1998); *see also In re* Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994); Hassen Imps. P'ship v. KWP Fin. VI (*In re* Hassen Imps. P'ship), 256 B.R. 916, 924 (B.A.P. 9th Cir. 2000); *In re* Vanderveer Estates Holdings, Inc., 283 B.R. 122, 134 (Bankr. E.D.N.Y. 2002); Cunningham v. Am. Automatic Sprinkler, Inc. (*In re* Trinity Meadows Raceway, Inc.), 252 B.R. 660, 668 (Bankr. N.D. Tex. 2000); *In re* Bohling, 222 B.R. 340, 342 (Bankr. D. Neb. 1998); *In re* Liberty Warehouse Assocs. Ltd. P'ship, 220 B.R. 546, 550 (Bankr. S.D.N.Y. 1998); *In re* Vest Assocs., 217 B.R. 696, 702 (Bankr. S.D.N.Y. 1998); *In re* Maywood, Inc., 210 B.R. 91, 93 (Bankr. N.D. Tex. 1997).

[51] *Vest Assocs.*, 217 B.R. at 703–04; *Trinity Meadows*, 252 B.R. at 669; Foss v. Boardwalk Partners (*In re* Boardwalk Partners), 171 B.R. 87, 92 (Bankr. D. Ariz. 1994).

their prepetition claims (including postpetition interest) courts have tended to award postpetition interest to secured creditors at the default rate.[52] As discussed above in relation to solvent debtor situations, the effect the use of the default rate would have on the equity holders is not one of the "fairness" considerations that militates in favor of a lower rate.[53] In fact, as discussed with respect to solvent debtor cases, even courts that have declined to apply the default rate out of consideration for competing creditors have advocated the "second cut" approach, whereby any funds remaining after all general unsecured creditors are paid in full would be distributed to the oversecured creditors on account of the default rate before any value is returned to the equity.[54]

In many respects, the approach courts have taken with respect to default rate interest in oversecured creditor situations mirrors the manner in which contract rate of interest is applied in solvent debtor cases.[55] Courts tend to apply a lower rate than that which was agreed upon in order to protect the interests of competing creditors.[56] But, when other creditors would not be adversely affected by use of the governing contract rate, courts also tend to honor the prepetition bargain struck between the debtor and the creditor.[57]

2. *Unethical Behavior*

At least one bankruptcy court has declined to award postpetition interest at the contract rate where the creditor to whom postpetition interest was owed had acted unethically, and the debtors' exit from bankruptcy had been delayed

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[52] *See Southland*, 160 F.3d at 1060 ("We find it especially significant—as did the bankruptcy court—that no junior creditors will be harmed if the Banks are awarded default interest."); *see also Vanderveer Estates*, 283 B.R. at 134 ("If a debtor is solvent, there is much more leeway to grant the default rate because other creditors will not be injured." (quoting *Vest Assocs.*, 217 B.R. at 703)); *Liberty Warehouse*, 220 B.R. at 551 (awarding the default rate interest, among other things, because the debtor had proved to be solvent).

[53] *See, e.g.*, *Terry*, 27 F.3d at 244–45 (creditor should not be deprived of bargained-for right in order to benefit equity); *see also In re* Courtland Estates Corp., 144 B.R. 5, 9 (Bankr. D. Mass. 1992) (noting that application of anything less than default rate of interest would provide an "undeserved windfall to the Debtor").

[54] *See, e.g.*, *Maywood*, 210 B.R. at 93.

[55] Compare *Southland*, 160 F.3d at 1059–60 (noting that default rate interest for an oversecured creditor is appropriate unless it produces an inequitable result), *with In re* Coram Healthcare Corp., 315 B.R. 321, 346 (Bankr. D. Del. 2004) (stating that determination of fair and equitable interest rate for contract claimants will turn on specific facts of case).

[56] *See supra* note 40 and accompanying text.

[57] *See supra* notes 46–47 and accompanying text.

as a result of the associated complications.[58] In *Coram Healthcare*, the United States Bankruptcy Court for the District of Delaware declined to award postpetition interest at the contract rate after considering the conflict of interest that existed (and initially was undisclosed) between one of the creditors and the debtor's chief executive officer. In issuing its decision, the court explicitly noted that the complications resulting from the conflict of interest had extended the duration of the debtors' chapter 11 cases, costing the estates $5 to $6 million in additional professional fees and $7 to $9 million in business losses.[59] The court held that under those circumstances, it would not be fair and equitable to award postpetition interest at the governing contract rate of interest.[60]

3. *Administrative Efficiency*

One additional rationale for applying the federal judgment rate to contract-based debt is that use of a single, uniform rate is the "most judicially efficient and practical manner of allocating [the debtor's] remaining assets."[61] A concern with the contract rate approach, as articulated by one court, is that "[c]alculating the appropriate rate and amount of interest to be paid to a myriad of investors has the potential to overwhelm what could otherwise be a relatively simple process."[62] Notwithstanding this concern, the Ninth Circuit acknowledged, in *Cardelucci*, that administrative efficiency "may be of limited relevance in certain bankruptcy proceedings," particularly where only a handful of contracts exist under which interest rate calculations would be required, and where capable financial advisors have been retained to perform any complex calculations that might be required.[63]

CONCLUSION

Courts have employed divergent approaches in dealing with the issue of postpetition interest in solvent debtor cases. Under the traditional approach, all

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[58] *Coram Healthcare*, 315 B.R. at 346–47 (acknowledging that contract rate postpetition interest may be awarded under § 1129(b), but declining to apply that rate after determining that the debtors' largest noteholder had acted unethically).

[59] *Id.* at 347 n.15.

[60] *Id.* at 347. Although the result in *Coram Healthcare* was driven largely by peculiar facts, the case underscores that in addressing these issues, courts often are guided by notions of "fairness." *See supra* note 35 and accompanying text.

[61] *In re* Cardelucci, 285 F.3d 1231, 1236 (9th Cir. 2002).

[62] *Id.*

[63] *Id.*

unsecured creditors receive postpetition interest at the federal judgment rate regardless of any rate that may have been agreed upon between the debtor and its creditors. The decision to interpret the term "the legal rate"—as used in § 726(a)(5)—to mean the federal judgment rate was motivated in large part by concerns over the potential prejudice to competing creditors if varying rates were applied, and the desire for uniformity of application and administrative efficiency.[64] The traditional approach undeniably addresses these concerns.

Notwithstanding the obvious benefits, the traditional approach suffers from at least two serious defects. First, this approach fails to take account of the fair and equitable principle § 1129(b), which requires the "payment in full" to all holders of senior claims before holders of junior claims receive any distribution.[65] In light of § 1129(b) and given the inexact nature of the "payment in full" concept, the Bankruptcy Code should be interpreted to offer courts a substantial degree of discretion in determining what additional amounts ought to be awarded to creditors beyond the federal judgment rate amount.[66] Second, the traditional approach applies the federal judgment rate in all situations without taking into account the facts and circumstances of the chapter 11 case, including any factors that may mitigate the concerns that motivated courts in the first instance to apply the federal judgment rate under § 726(a)(5).[67]

Under the revised approach, courts have the discretion to award postpetition interest beyond what is required under § 726(a)(5) up to the contract rate, and therefore are afforded the flexibility to enforce the rates agreed upon between the debtor and its creditors under the appropriate circumstances.[68] For example, in fully solvent chapter 11 cases—where even trade creditors will receive the full amount of their claims plus postpetition interest at the federal judgment rate—courts have the discretion to give creditors with contract-based claims the benefit of their bargain with the debtor by applying the contract rate of interest.[69] Courts that employ this approach recognize that the best interests of creditors test merely establishes the minimum amount of interest that must be paid (not less than would be paid in a chapter 7 liquidation), while leaving open the possibility that the fair and

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64 *See supra* Part II.A.

65 *See supra* notes 22–26 and accompanying text.

66 *See supra* notes 41–42 and accompanying text.

67 *See supra* Parts II.A–B.

68 *See supra* Part II.B.

69 *Id.*

equitable test will require a solvent debtor to pay more.[70] Under the revised approach, courts also are free to consider the conduct of creditors in the course of the bankruptcy case in determining whether any amounts in addition to the federal judgment rate amount should be awarded.[71] Thus the revised approach not only is more faithful to the plain meaning and structure of the Bankruptcy Code, but it also strikes a better balance among competing stakeholder claims and interests by allowing courts to consider the particular facts and circumstances in determining the applicable rate of postpetition interest in solvent debtor cases.

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70 *Id.*

71 *See supra* text accompanying notes 41–42.