PG&E Judge Rules that Postpetition Interest for Unsecured Creditors of Solvent Debtors Accrues at Federal Judgment Rate, Finding that Statutory Curtailment of Rights Does Not Constitute Impairment

01 / 09 / 20

Skadden

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Ron E. Meisler
Partner / Chicago
312.407.0549
ron.meisler@skadden.com

Christopher M. Dressel
Associate / Chicago
312.407.0968
christopher.dressel@skadden.com

Zahed A. Haseeb
Associate / Chicago
312.407.0685
zahed.haseeb@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

155 N. Wacker Drive
Chicago, Illinois 60606
312.407.0700

On December 30, 2019, Judge Dennis Montali of the United States Bankruptcy Court for the Northern District of California, presiding over the PG&E bankruptcy case,[1] issued a memorandum decision regarding a dispute between the debtors (the PG&E Debtors) and certain of their unsecured creditors — including the Official Committee of Unsecured Creditors, the Ad Hoc Committee of Senior Unsecured Noteholders and the Ad Hoc Committee of Holders of Trade Claims (together, the Unsecured Creditors) — over the applicable postpetition rate of interest for unsecured claims against a solvent debtor.[2] Judge Montali found that the Ninth Circuit's decision in *In re Cardelucci* was binding on the bankruptcy court and required the court to hold that postpetition interest accrues at the federal judgment rate, not a contractual or other rate of interest. In his decision, Judge Montali cited the recent decision in *In re Ultra Petroleum*, in which the Fifth Circuit examined the disallowance of claims for postpetition interest and make-whole premiums. While remanding on certain threshold issues, the Fifth Circuit held that the Bankruptcy Code's disallowance of such claims would not constitute impairment under a chapter 11 plan because the disallowance is imposed by statute, not the plan. Judge Montali discussed this same principle — that statutory curtailment of rights is not plan impairment — as an independent basis for ruling in favor of the PG&E Debtors. Subject to any appeals of this ruling, Judge Montali's decision results in approximately $500 million less postpetition interest payable to the holders of the relevant claims.

The PG&E Debtors' Plan and Supporting Argument

The PG&E Debtors filed a version of their chapter 11 plan of reorganization on November 4, 2019 (the Plan),[3] which listed unsecured funded debt claims and general unsecured claims as unimpaired, providing that they would be paid in full, in cash, including postpetition interest at the federal judgment rate provided in 28 U.S.C. § 1961(a) (the Federal Judgment Rate). In support of this treatment, the PG&E Debtors filed a brief presenting the basis for using the Federal Judgment Rate (calculated to be 2.59%) rather than contractual or state law interest rates.[4] The PG&E Debtors' argument relied heavily on the Ninth Circuit's decision in *In re Cardelucci*, which they described as unequivocally holding that, per Bankruptcy Code Section 726(a)(5), postpetition interest is payable to unsecured creditors of a solvent debtor at the "legal rate," *i.e.* the Federal Judgment Rate.[5]

Section 502(b)(2), Section 726(a)(5) and *Cardelucci*

Bankruptcy Code Section 502(b)(2) disallowance of claims for "unmatured interest" operates as a general prohibition of claims for postpetition interest on unsecured claims.[6] Courts, such as the Ninth Circuit in *Cardelucci*, have found that Section 726(a)(5) of the Bankruptcy Code — which permits the "payment of interest at the legal rate from the

[1] The PG&E bankruptcy case is captioned *In re PG&E Corp.*, No. 19-30088 (DM) (Bankr. N.D. Cal. filed Jan. 29, 2019).

[2] See Memorandum Decision Regarding Postpetition Interest, *In re PG&E Corp.*, No. 19-30088 (DM) (Bankr. N.D. Cal. Dec. 30, 2019), ECF No. 5226 (Memorandum Decision).

[3] See Debtors' Joint Chapter 11 Plan of Reorganization Dated November 4, 2019, *In re PG&E Corp.*, No. 19-30088 (DM) (Bankr. N.D. Cal. Nov. 4, 2019), ECF No. 4563.

[4] See Debtors' Brief Regarding Applicable Rate of Postpetition Interest on Allowed Unsecured Claims and Joinder of PG&E Shareholders, *In re PG&E Corp.*, No. 19-30088 (DM) (Bankr. N.D. Cal. Nov. 8, 2019), ECF No. 4624.

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

[6] *In re Del Mission Ltd.*, 998 F.2d 756, 757 (9th Cir. 1993); see also 4 Alan N. Resnick & Henry J. Sommer, *Collier on Bankruptcy* ¶ 502.03 (16th ed. 2019) (discussing "[t]he principle that interest stops running form the date of the filing of the petition").

date of the filing of the petition" on any claim against a solvent chapter 7 debtor — provides an avenue for the payment of postpetition interest even in the chapter 11 context.

Regarding the question of how much interest should be paid, the PG&E Debtors insisted that the *Cardelucci* decision was dispositive. In *Cardelucci*, the Ninth Circuit considered an objection from unsecured creditors to the confirmation of a plan of reorganization that proposed to pay postpetition interest on the objecting creditors' litigation claim at the Federal Judgment Rate rather than the much higher California statutory interest rate. The Ninth Circuit ruled in favor of the debtor, finding that Section 726(a)(5)'s use of the phrase "interest at the legal rate" demonstrates a Congressional intent to apply a single statutory rate of interest — namely, the Federal Judgment Rate — when calculating postpetition interest on unsecured claims against solvent debtors. Moreover, the Ninth Circuit reasoned, the use of the Federal Judgment Rate promotes uniformity across different parts of federal law and ensures the equitable treatment of creditors. Finally, while acknowledging that using the Federal Judgment Rate could give debtors a windfall, the Ninth Circuit rejected the objectors' appeal to equitable principles, finding the phrase "interest at the legal rate" to be a "statutory term with a definitive meaning that cannot shift depending on the interests invoked by the specific factual circumstances before the court."[7]

The Unsecured Creditors' Response

The Unsecured Creditors argued that their claims could not be treated as unimpaired unless they received postpetition interest according to the rates mandated by the applicable contracts or state laws.[8] In support of their position, the Unsecured Creditors relied on Bankruptcy Code Section 1124(1), which states that a claim is impaired unless "the plan . . . leaves unaltered the legal, equitable, and contractual rights to which such claim . . . entitles the holder of such claim." Relying on courts' interpretation of the phrase "legal, equitable, or contractual rights" in Section 1124(2), the Unsecured Creditors argued that the analogous phrase in Section 1124(1) referred to state law rights, concluding that their claims were impaired unless they received the treatment they were entitled to under state law, which would include payment of postpetition interest at the contractual rate, if applicable.

According to the Unsecured Creditors, by paying postpetition interest at the Federal Judgment Rate rather than the contractual or state law (*i.e.* non-bankruptcy) rates, the Plan altered the Unsecured Creditors rights and thus could not treat them as unimpaired. In the Unsecured Creditors' view, because the Plan impaired their claims, the PG&E Debtors were subject to Bankruptcy Code Section 1129(b)'s requirement that a plan be "fair and equitable" with respect to each impaired, non-accepting class of claims. Under Section 1129(b), where an impaired class of claimholders rejected a chapter 11 plan, junior classes — including equity holders — may not receive any plan recoveries on account of their claims or interests. The PG&E Debtors' Plan proposed to reinstate all equity interests, subject to dilution in the case of one out of the four equity classes. To grant such recoveries to equity holders and be "fair and equitable," the Unsecured Creditors argued, the Plan needed to pay the Unsecured Creditors' claims in full, including postpetition interest at contractual rates. Whether through Section 1124(1) or 1129(b), the Unsecured Creditors' position relied on the fact that the PG&E Debtors cannot provide a recovery to equity holders while impairing the claims of the Unsecured Creditors, unless the Unsecured Creditors agreed to such a treatment and accepted the Plan.

The Unsecured Creditors argued that *Cardelucci*'s holding should be limited to the narrow issue of interpreting Section 726(a)(5). Because the Ninth Circuit in *Cardelucci* did not address Section 1124 or 1129(b), the Unsecured Creditors argued that the decision had "no bearing on the question of which postpetition interest rate should be paid to make a class of unsecured claims unimpaired or [whether] a plan [is] fair and equitable with respect to such class." Ultimately the Unsecured Creditors relied on the notion that the Bankruptcy Code's requirements for the non-impairment of claims under a chapter 11 plan — not Section 726(a)(5) — were determinative of the correct postpetition interest rate.

Judge Montali Finds *Cardelucci* Is Binding

Following briefing and oral argument on the issue, Judge Montali ruled in favor of the PG&E Debtors, finding that *Cardelucci* was binding. Contrary to the Unsecured Creditors' assertion that *Cardelucci* was applicable only to the narrow issue of how to define "legal rate," Judge Montali found that the Ninth Circuit's unequivocal holding was that "unsecured creditors of a solvent debtor will be paid the Federal Interest Rate whether their prepetition contracts call for higher or lower rates, or applicable state law judgment rates are higher, or there are no other applicable

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

[8] See Consolidated Opening Brief of the Official Committee of Unsecured Creditors and Other Creditor Groups and Representatives Regarding the Appropriate Postpetition Interest Rate Payable on Unsecured Claims in a Solvent Debtor Case, *In re PG&E Corp.*, No. 19-30088 (DM) (Bankr. N.D. Cal. Nov. 8, 2019), ECF No. 4634.

rates to consider."[9] He rejected the Unsecured Creditors' argument that *Cardelucci* was inapplicable to the question of how to render a claim unimpaired, finding that, "[w]hile the [Ninth Circuit in *Cardelucci*] pinpointed a narrow but important issue, it did not narrow the application of its holding, which must be applied broadly given the structure of the Bankruptcy Code and the clear and plain meaning of its applicable provisions."[10]

Judge Montali's Independent Basis for Ruling

Although he could have reached his decision purely based on *stare decisis*, Judge Montali noted that he would have reached the same decision even if *Cardelucci* were inapplicable. In reaching an independent basis for holding in favor of the PG&E Debtors, Judge Montali relied on a "holistic" interpretation of the relevant statutory provisions. Specifically, he found that Section 1124(1) could not be the source of the right to postpetition interest in light of Section 502(b)(2)'s general disallowance of claims for unmatured interest. To find otherwise, Judge Montali reasoned, "would require the court to ignore not only the plain words of the statute but also the holistic notion of treating them as part of a combined comprehensive instrument of definitions, applicability and implementation."[11]

Where Section 1124(1) specifically discusses impairment in the context of rights being altered by a plan, the disallowance of claims for postpetition interest is a function of Section 502(b)(2). "[T]he Unsecured Creditors' complaint is with Congress and the Bankruptcy Code, not the drafters of a Plan. The Bankruptcy Code, not the Plan, limits them to the Federal Interest Rate."[12]

[9] Memorandum Decision at 8.

[10] Judge Montali remarked that in light of Section 502(b)(2)'s general prohibition of claims for postpetition interest, the *Cardelucci* court's application of Section 726(a)(5) was the basis for the Unsecured Creditors' entitlement to postpetition interest (Memorandum Decision at 8). As such, although section 726(a)(5) is essential to the inquiry of how much interest to allow, its relevance to solvent chapter 11 debtors is based on case law precedent, not a statutory mandate. Moreover, because of the disallowance of unmatured interest rates under Section 502(b)(2), the right to postpetition interest is not a *claim* for postpetition interest; rather, it is the right to interest *on* the underlying claim, based on a judicial interpretation and application of Section 726(a)(5).

[11] Memorandum Decision at 4.

[12] *Id.* at 4.

As such, Judge Montali found that Section 1124(1) is satisfied; the Plan "leaves unaltered the legal, equitable, and contractual rights" of the Unsecured Creditors to the extent permitted by the Bankruptcy Code, rendering the Unsecured Creditors unimpaired. Judge Montali also found considerations of whether a plan is "fair and equitable" to be inapplicable, since Section 1129(b) specifically refers to impaired, non-accepting classes of claimholders. If, as Judge Montali determined, the Unsecured Creditors are unimpaired classes, they are deemed to accept the Plan.

To reinforce the view that statutory curtailment of rights does not constitute impairment for the purposes of the Bankruptcy Code, Judge Montali's decision refers to the two circuit courts that have analyzed the issue previously. The Third Circuit in *In re PPI Enterprises* considered the question of whether a landlord whose lease termination claim was not paid in full due to the Bankruptcy Code's limitation on landlord damages was impaired on account of this limitation.[13] More recently, the Fifth Circuit in *In re Ultra Petroleum* considered the question of whether limitations on make-whole payments and postpetition interest under Section 502(b)(2)'s disallowance of unmatured interest constituted impairment.[14] In both cases, the courts found that claims are not rendered impaired by a plan when the plan in question limits the claim only to the extent required to comply with the Bankruptcy Code's disallowance provisions. Stated differently, "[w]here a plan refuses to pay funds disallowed by the Code, the Code — not the plan — is doing the impairing."[15]

[13] *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 201-02 (3d Cir. 2003).

[14] *In re Ultra Petroleum Corp.*, 943 F.3d 758, 765 (5th Cir. 2019).

[15] *In re Ultra Petroleum Corp.*, 943 F.3d 758, 765 (5th Cir. 2019). Because the bankruptcy court in *Ultra Petroleum* held that the Bankruptcy Code's limitations on unmatured interest did constitute impairment for the purposes of section 1124(1), it did not decide the questions of whether the Bankruptcy Code disallows make-whole premiums as unmatured interest, how much interest the debtors must pay the relevant creditors or whether the solvent debtor exception applied in the first place. Accordingly, the Fifth Circuit remanded these issues to the bankruptcy court following its reversal on the issue of impairment. This decision vacates and supersedes the Fifth Circuit's previous decision on the matter, *In re Ultra Petroleum Corp.*, 913 F.3d 533 (5th Cir. 2019), *opinion withdrawn and superseded*, 943 F.3d 758 (5th Cir. 2019), which contained the same holding with respect to impairment but also opined (in dicta) that make-whole premiums should likely be disallowed and that the creditors in question did not have a legal right to postpetition interest.