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## Problems in the Code

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### Clarifying the Calculation of Post-Petition Interest



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In its initial decision in the *Ultra Petroleum* case, the Fifth Circuit commented that Ultra's status as a solvent debtor in bankruptcy made it as "rare as the proverbial rich man who manages to enter the Kingdom of Heaven."<sup>1</sup> While the solvent debtor might be rare, there have been multiple recent high-profile bankruptcy cases involving solvent debtors.

In many of these cases, the payment of post-petition interest has been a contested issue, with disputes over whether post-petition interest must be paid and, if so, at what rate.<sup>2</sup> The resulting cases have disagreed on these questions due to two specific problems with the Bankruptcy Code: one involving ambiguous language, the other involving the absence of language.

The problem of ambiguous language resides in § 726(a)(5), which provides creditors in chapter 7 cases where the debtor is solvent with "interest at the legal rate" on their claims. Courts have been split on what "interest at the legal rate" means, with some finding that this refers to the federal-judgment (FJ) rate of interest found in 28 U.S.C. § 1961(a), and others finding that it refers to any specific rate applicable to the particular claim, including the rate provided by a valid state law contract (the "contract rate").

The problem of absence of language relates to the payment of post-petition interest to unimpaired creditors in chapter 11 cases. While it is accepted that post-petition interest should be paid to unimpaired creditors in chapter 11 cases where the debtor is solvent, there is a complete absence of statutory guidance as to how that interest should be calculated.

Congress should fix these problems by amending § 726(a)(5) to clarify that post-petition interest should be calculated pursuant to the contract rate, consistent with the longstanding principle, embodied in the so-called solvent-debtor exception (SDE), that solvent debtors should honor valid state law obligations to creditors in full before returning surplus to equity. Congress should also amend § 1124(1) to provide for the same method for calculating interest in connection with unimpaired claims in chapter 11 cases where the debtor is solvent. This will not only provide clear statutory authority for the payment of post-petition interest, it will also provide for the uniform calculation of such interest consistent with the SDE.

#### The Current Statutory Scheme

Section 502(b)(2) of the Bankruptcy Code specifically excludes from an "allowed claim" all amounts for "unmatured interest," which is interpreted to mean interest accruing on the claim following the date that the bankruptcy has been filed and the economic equivalent of such interest.<sup>3</sup> In contrast, § 726(a)(5) specifically provides that before any surplus in a chapter 7 case can be returned to the debtor, creditors must receive "payment of interest at the legal rate from the date of the filing of the petition" on any claim paid in the case. Courts have reconciled these provisions by finding that § 726(a)(5) permits the payment of interest "on a claim," as opposed to "as part" of an allowed claim.<sup>4</sup>

Section 726(a)(5) is not only relevant to chapter 7 cases. In chapter 11 cases involving a cramdown of an impaired class of claims pursuant to § 1129(a)(7)(B), the plan must satisfy the best-in-

<sup>1</sup> *In re Ultra Petroleum Corp.*, 913 F.3d 533, 537 (5th Cir. 2019) ("*Ultra I*").

<sup>2</sup> See, e.g., *In re Hertz Corp.*, 2024 WL 4132132 (3d Cir. Sept. 10, 2024); *In re PG&E Corp.*, 46 F.4th 1047, 1056 (9th Cir. 2022); *In re LATAM Airlines Grp. S.A.*, No. 20-11254, 2022 WL 2206829 (Bankr. S.D.N.Y. June 18, 2022).

<sup>3</sup> See *In re Ultra Petroleum Corp.*, 51 F.4th 138, 145 (5th Cir. 2022) ("*Ultra II*").

<sup>4</sup> See *PG&E*, 46 F.4d at 1058-59; *Ultra I*, 913 F.3d at 765.

terests-of-creditors test by providing those impaired creditors with distributions that are not less than what they would receive in a chapter 7 case.<sup>5</sup> If the debtor is solvent, those impaired creditors must receive interest “at the legal rate,” as that is what they would receive in a chapter 7 case.

No Code provision directly provides for the payment of post-petition interest to *unimpaired* creditors in chapter 11. However, Congress has made clear that for unsecured creditors to be considered unimpaired in a solvent-debtor case for purposes of § 1124, which governs impairment in chapter 11 cases, they must be paid *some amount* of post-petition interest. Before 1994, § 1124 contained subsection (3), which provided that a creditor was unimpaired if it received cash equal to the “allowed amount” of its claim. When a bankruptcy court interpreted this subsection to allow a solvent debtor to exclude post-petition interest from an unimpaired creditor’s treatment,<sup>6</sup> Congress swiftly repealed subsection (3).

The legislative history makes it clear that Congress did so because it viewed the denial of post-petition interest to creditors in a solvent-debtor case to be an “unfair result.”<sup>7</sup> “Post-*New Valley* courts all agree that a solvent debtor must pay creditors some post-petition interest to classify their claims as unimpaired.”<sup>8</sup>

## The Problem

The phrase “interest at the legal rate” as used in § 726(a)(5) is ambiguous, which has resulted in different interpretations of the phrase by courts. Also, because no Bankruptcy Code section specifically addresses the payment of post-petition interest to unimpaired creditors in a chapter 11 case, courts have disagreed on how such interest should be calculated.

## The Meaning of “Interest at the Legal Rate”

The Ninth Circuit is the only circuit to directly address the meaning of “interest at the legal rate” in § 726(a)(5), finding, in the *Cardelucci* case, that it refers to the payment of interest at the FJ rate.<sup>9</sup> This ruling was based in part on legislative history.

Before it was finalized, the original language proposed for § 726(a)(5) was “interest on claims allowed.” The Ninth Circuit found this modification from a general statement to a specific phrase to be an indication that Congress intended a uniform rate to apply.<sup>10</sup> The Ninth Circuit concluded that, as a policy concern, use of one uniform rate would promote both fairness among creditors and ease of administration by avoiding the need to calculate multiple different interest rates.<sup>11</sup> It also likened a claim in bankruptcy to a judgment, making application of the FJ rate logical, as that is the rate that applies to judgments rendered in federal court.<sup>12</sup> Other

courts have followed *Cardelucci* and interpreted § 726(a)(5) to refer to the FJ rate.<sup>13</sup>

While it did not specifically disagree with *Cardelucci*, the Fifth Circuit in *Ultra II* called into question the Ninth Circuit’s reasoning by suggesting that if *Congress* had meant for the FJ rate to apply, it could have cross-referenced the statute.<sup>14</sup> Other courts have specifically disagreed with *Cardelucci*. In *Dvorkin Holdings*, the district court determined that § 726(a)(5) codified the pre-Bankruptcy Code SDE, and that the SDE provides that bankruptcy courts should enforce creditors’ rights according to the terms of their contracts when the bankruptcy estate has sufficient assets to pay all creditors in full. Per this reasoning, “interest at the legal rate” refers to interest at the contract rate.<sup>15</sup> At least one other bankruptcy court has also found that § 726(a)(5) requires payment of interest at the contract rate due, in large part, to the SDE.<sup>16</sup>

## Calculation of Post-Petition Interest for Unimpaired Creditors

As previously noted, § 726(a)(5) does not directly apply to unimpaired creditors in a chapter 11 case. However, Congress has made it clear that creditors in solvent-debtor cases must receive *some amount* of post-petition interest in order to be deemed unimpaired. Absent specific guidance, courts have come to different conclusions as to how such post-petition interest should be calculated.

In *Ultra II*, the Fifth Circuit determined that interest should be paid at the contract rate to unimpaired, unsecured creditors where a debtor is solvent, because the SDE survived the Bankruptcy Code; therefore, when a debtor is solvent, it is the role of the bankruptcy court to enforce creditors’ valid contractual rights in full.<sup>17</sup> The Ninth Circuit held similarly in *PG&E*, concluding that the SDE’s “core principle that creditors should be made whole when the bankruptcy estate is sufficient” entitles unimpaired creditors in a chapter 11 case to post-petition interest at the contract rate absent “compelling equitable considerations.”<sup>18</sup>

The *PG&E* court distinguished *Cardelucci* as “merely” interpreting § 726(a)(5), which is inapplicable to unimpaired chapter 11 creditors, and not establishing a broad rule that all unsecured claims in solvent-debtor cases are entitled only to post-petition interest at the FJ rate.<sup>19</sup> The Seventh and First Circuits also have held that the SDE creates a presumption that interest will be paid to creditors at the contract rate where a debtor is solvent.<sup>20</sup>

In *Hertz*, the Third Circuit determined that the payment of post-petition interest to unimpaired creditors is required by the absolute-priority rule, which codified the common law

5 See *PG&E*, 46 F.4d at 1059.

6 *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994).

7 H.R. Rep. No. 103-835 at 47-48 (1994), reprinted in 1994 U.S.C.C.A.N. 3340, 3356-57, 1994 WL 562232.

8 *PG&E*, 46 F.4d at 1062 (citing *In re Ultra Petroleum*, 624 B.R. 178, 203-04 (Bankr. S.D. Tex. 2020)); *In re Energy Future Holdings Corp.*, 540 B.R. 109, 124 (Bankr. D. Del. 2015); *Hertz*, 637 B.R. at 800-01.

9 *In re Cardelucci*, 285 F.3d 1231, 1234 (9th Cir. 2002).

10 See *id.* at 1234-35.

11 *Id.* at 1235-36.

12 *Id.* at 1235.

13 See, e.g., *LATAM*, 2022 WL 2206829, at \*18; *In re Robinson*, 567 B.R. 644, 646 (Bankr. N.D. Ga. 2017).

14 See *Ultra II*, 51 F.4th at 159, n.26.

15 *In re Dvorkin Holdings LLC*, 547 B.R. 880, 897 (N.D. Ill. 2016). The *Dvorkin Holdings* court was guided by the Seventh Circuit’s decision in *In re Fesco Plastics Corp. Inc.*, 996 F.2d 152, 155-56 (7th Cir. 1993), which described § 726(a)(5) as a codification of the SDE.

16 See *In re Hicks*, 653 B.R. 562, 572-73 (Bankr. N.D. Ill. 2023).

17 See *Ultra II*, 51 F.4th at 155-56.

18 *PG&E*, 46 F.4th at 1061.

19 See *id.* at 1056.

20 See *In re Dow Corning Corp.*, 456 F.3d 668, 680 (6th Cir. 2006); *Gencarelli v. UPS Cap. Bus. Credit*, 501 F.3d 1, 7 (1st Cir. 2007).

absolute-priority rule and, by doing so, the SDE.<sup>21</sup> However, the Third Circuit held that the absolute-priority rule does not always require payment of interest at the contract rate, but rather “imposes the equitable rate of post-petition interest, whatever that may be.”<sup>22</sup> In doing so, the Third Circuit cited *Energy Future Holdings*, where the bankruptcy court found that under equitable principles embodied in the absolute-priority rule, the court could award post-petition interest that “may be at the contract rate or such other rate as the Court deems appropriate.”<sup>23</sup>

In *LATAM*, the bankruptcy court disagreed with *Ultra II*, finding that interest at the contract rate is contrary to “the express prohibition of unmatured interest on claims under § 502(b)(2)” and “mischaracterizes the degree to which (and how) the [SDE] has survived” the Code.<sup>24</sup> The bankruptcy court held that the SDE survived the Code only through § 1129(a)(7)’s incorporation of § 726(a)(5), therefore if the debtor were solvent, unimpaired creditors would only be entitled to interest at the FJ rate.<sup>25</sup>

## Conclusion

The cases discussed herein illustrate two clear and inter-related problems with the Bankruptcy Code. First, the phrase “interest at the legal rate” as used in § 726(a)(5) is ambiguous and has resulted in a split where some courts interpret the phrase to refer to the FJ rate, while others have found, consistent with the SDE, that the “legal rate” is the contract rate. Second, while Congress has made it clear through the repeal of § 1124(3) that *some* amount of post-petition interest must be paid on unimpaired claims where a debtor is solvent, the Code contains no provision expressly providing for the payment of such interest or for a method of calculation. With this absence of guidance from the Code, the Fifth and Ninth Circuits in *Ultra* and *PG&E* have found that the SDE entitles creditors to payment of interest at the contract rate. The Third Circuit in *Hertz* has found that an equitable rate of interest should be paid, while the bankruptcy court in *LATAM* felt constrained by § 726(a)(5) to award interest only at the FJ rate.

These problems can be fixed by amending both §§ 726(a)(5) and 1124(1) to specifically provide for a uniform method for calculation of post-petition interest to be paid when a debtor is solvent. The method for calculation should be the contract rate, as this is consistent with the pre-Code principle, embodied in the SDE, that a solvent debtor that can honor the terms of its contracts should do so. If not, entities that could otherwise pay their debts in full will be incentivized to file for bankruptcy to void contractual obligations that would otherwise be deemed valid under applicable state law. This fix can be accomplished by amending §§ 726(a)(5) and 1124(1) as follows (in bold):

### **Amended § 726(a)(5):**

**“(5) fifth, in payment of interest ~~at the legal rate~~ calculated at the rate specified by**

**applicable law, including the rate specified by a valid contract,** from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection.”

### **Amended § 1124(1):**

**“leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest, including, providing for the payment of interest through the date such claim or interest is paid calculated at the rate specified by applicable law, including, the rate specified by a valid contract, before distributions can be made on junior claims or interests.”** **abi**

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<sup>21</sup> See *Hertz*, 2024 WL 4132, at \*14.

<sup>22</sup> *Id.*

<sup>23</sup> *Energy Future Holdings*, 540 B.R. at 124.

<sup>24</sup> See *LATAM*, 2022 WL 2206829, at \*21.

<sup>25</sup> See *id.* at \*18.